

5-1-2008

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### Recommended Citation

Steven A. Dean, *The Incomplete Global Market for Tax Information*, 49 B.C.L. Rev. 605 (2008),  
<http://lawdigitalcommons.bc.edu/bclr/vol49/iss3/1>

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# THE INCOMPLETE GLOBAL MARKET FOR TAX INFORMATION

STEVEN A. DEAN\*

**Abstract:** The United States finds itself facing a growing disparity between the tax information it collects domestically and the tax information it is able to acquire from abroad. At the same time, globalization and technology have made it easier for taxpayers to ignore national borders and have therefore made the ability to acquire useful extraterritorial tax information more important than ever. To make the income tax effective in today's borderless economy, the United States must abandon the antiquated notion of information exchange. Creating a more complete market—one more likely to facilitate efficient transactions than today's barter market in extraterritorial tax information—is one possible remedy. The United States could also choose (1) to promote a supranational effort like the European Union Savings Directive to facilitate cross-border flows of tax information, (2) to reduce unilaterally its dependence on extraterritorial tax information, or (3) to pursue all of these possibilities simultaneously. Any of those strategies would be more likely to ensure that the United States receives the extraterritorial tax information it needs than the eighty-year-old barter method in use today.

## INTRODUCTION

Information about individuals is bought and sold in ways that would have been unimaginable just a few decades ago,<sup>1</sup> and “a strong

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\* Copyright © 2008 Steven A. Dean, Associate Professor of Law, Brooklyn Law School. All rights reserved. This Article benefited from support from a Brooklyn Law School Dean's Summer Research Grant and from very helpful suggestions and comments from Rosanne Altshuler, Edward Cheng, Laura Pomeroy-Gerber, Megan Healey, Edward Janger, Claire Kelly, Vadim Mahmoudov, Ruth Mason, Chris Serkin, and Dan Shavero and from the participants in the Junior Tax Scholars Workshop at Boston University and a Brooklyn Law School Faculty Workshop. It also benefited from outstanding research assistance from Diana Sur and Ray Cheng.

<sup>1</sup> See Paul M. Schwartz, *Property, Privacy, and Personal Data*, 117 HARV. L. REV. 2056, 2062 (2004) (describing technologies such as “an implantable chip [that] generates a data trail by moving about real space, whether in a nursing home, a retail store, or the outdoors” and noting that “these personal data can be commodified and exchanged for additional services or special discounts”). New technologies are increasingly enabling “individual Americans . . . [to] participat[e] in the commodification of their personal data.” See *id.* at 2057 & n.3. All sorts of information and related rights (including the right *not* to receive

conception of personal data as a commodity is emerging in the United States."<sup>2</sup> As between willing buyers and sellers, those transactions are presumptively efficient. Because the commodity changing hands is information, however, those transactions can raise potentially troubling questions.<sup>3</sup>

Typically, the participants in such markets are individuals and businesses. Governments, although they often rely heavily on information, usually do not pay for that information.<sup>4</sup> Although they acquire enormous amounts of valuable information, they tend not to sell it.<sup>5</sup> This Article considers one instance in which governments both buy and sell information and have done so for many years.

The U.S. federal government's fight to close an annual "tax gap" of as much as \$353 billion<sup>6</sup> highlights both its reliance on information about taxpayers and the limits of its capacity to procure information that is both timely and useful.<sup>7</sup> That information deficit has been identified as a key obstacle both to reducing taxpayers' use of sophisticated

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certain kinds of information) could conceivably be sold in welfare enhancing transactions. See Ian Ayres & Matthew Funk, *Marketing Privacy*, 20 YALE J. ON REG. 77, 96-98 (2003) (proposing the creation of a market that would allow individuals to set a price at which they would be willing to receive telemarketing calls).

<sup>2</sup> Schwartz, *supra* note 1, at 2057.

<sup>3</sup> One unique and particularly troublesome problem is that once information is commodified, it can be difficult to maintain control over the ways it is used and who has access to it. In recent years, scholars have begun to focus on how to create an "information privacy" regime that can adequately "govern the use, transfer, and processing of personal data." See *id.* at 2058. Information privacy is only one of several concerns this Article addresses. Part IV considers three normative justifications for trading in, and limiting trading in, taxpayers' information: potential social welfare gains, distributional issues, and information privacy. See *infra* notes 337-411 and accompanying text.

<sup>4</sup> The primary exceptions to this rule are payments to those that provide information useful in law enforcement efforts. See, e.g., Eric Pfanner & Mark Landler, *Tax Inquiry? Principality is Offended*, N.Y. TIMES, Feb. 20, 2008, at C1 (noting that Germany's intelligence service bought information related to tax flight from an informant).

<sup>5</sup> One of the most prominent examples of information selling by governments is the practice of selling personal information collected by state departments of motor vehicles. See *Reno v. Condon*, 528 U.S. 141, 143-44 (2000) (describing purpose of the Driver's Privacy Protection Act of 1994).

<sup>6</sup> Max B. Sawicky, *Do It Yourself Tax Cuts: The Crisis in U.S. Tax Enforcement*, in BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 1, 1 (Max B. Sawicky ed., 2005). The tax gap, or the amount of unpaid tax, consists predominantly of underreported income with much smaller contributions from nonfiling and underpayment. *Id.* at 3.

<sup>7</sup> See Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 698 & n.13 (2007) (discussing importance of information reporting to taxpayer compliance).

tax shelters and to preventing garden-variety underreporting.<sup>8</sup> Accordingly, important reforms<sup>9</sup> and innovative proposals<sup>10</sup> have focused on narrowing that deficit.

The challenges a government faces in securing access to domestic tax information are even more formidable when the information it needs to enforce its tax laws rests outside its borders.<sup>11</sup> Governments must contend with both legal and practical limits on their power to compel foreign actors to provide them with that extraterritorial tax information.<sup>12</sup> Domestically, a government may impose ex ante regulatory requirements that certain information and transactions be reported by commercial intermediaries<sup>13</sup> and may then compel the production of supplemental information that becomes relevant with the benefit of hindsight.<sup>14</sup> Beyond its borders, those government powers are not reliable.<sup>15</sup>

That limitation has long attracted the attention of international tax experts.<sup>16</sup> In recent years, the fall of legal and technological barriers

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<sup>8</sup> See Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 601–05 (2006); David R. Tillinghast, *Issues of International Tax Enforcement*, in THE CRISIS IN TAX ADMINISTRATION 38, 38–39 (Henry J. Aaron & Joel Slemrod eds., 2004).

<sup>9</sup> See Treas. Reg. § 1.6011-4 (as amended in 2006) (requiring reporting with respect to potential tax avoidance transactions).

<sup>10</sup> See Raskolnikov, *supra* note 8, at 601–05 (proposing an alternative penalty to combat tax avoidance).

<sup>11</sup> See Tillinghast, *supra* note 8, at 39 (noting that “the largest single source of difficulty in administering the international aspects of the U.S. tax law is that a large part of the information the [Internal Revenue Service] needs is not directly available to it”).

<sup>12</sup> See *id.* (identifying jurisdictional limitations as a key factor in the Internal Revenue Service’s (the “IRS”) information shortage and noting that some statutory requirements are practically impossible to enforce).

<sup>13</sup> Lederman, *supra* note 7, at 697 (noting that “in a variety of situations, the federal government requires third parties to report to the government, with a copy to the taxpayer, amounts the payor transferred to the taxpayer”).

<sup>14</sup> I.R.C. §§ 7601–7613 (West 2002 & Supp. 2007) (authorizing various investigative and enforcement powers of IRS including summonses and power to execute search and arrest warrants, among others).

<sup>15</sup> See Tillinghast, *supra* note 8, at 39.

<sup>16</sup> See, e.g., U.S. Treasury Dep’t, United States Model Income Tax Convention art. 26 (2006) [hereinafter U.S. 2006 Model Convention], available at <http://www.ustreas.gov/press/releases/reports/hp16801.pdf>; United Nations, Model Double Tax Convention Between Developed and Developing Countries art. 26 (2001) [hereinafter U.N. 2001 Model Convention], available at <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan002084.pdf>; Reports Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.216M.85 1927 II, at 23 (1927) [hereinafter 1927 Report], available at [http://www.law.wayne.edu/tad/Documents/League/League\\_Tech\\_Experts.pdf](http://www.law.wayne.edu/tad/Documents/League/League_Tech_Experts.pdf); Org. for Econ. Cooperation & Dev., Draft Double Taxation Convention on Income and Capital (1963) [hereinafter OECD Double Taxation Draft], reprinted in 1963 AND 1977 ORGANI-

to international capital flows has transformed a troublesome vulnerability into a catastrophic failure of tax administration.<sup>17</sup> In part because taxpayers have proven adept at exploiting modern telecommunications and information technology to hide tax information overseas, globalization and technological change have thrust the problem of acquiring extraterritorial tax information into the spotlight.<sup>18</sup>

As is frequently true, governments have proven less nimble than the private sector and have struggled to keep pace. The primary tool for gathering extraterritorial tax information is bilateral tax information exchange.<sup>19</sup> Bilateral information exchange provisions allow pairs of governments to barter with one another, each supplying information that the other can use to enforce its taxes.<sup>20</sup> Pursuant to this barter system, one country commits to sending lists of taxpayer-specific information to another country in exchange for the right to receive similar lists. The use of consideration other than tax information is generally not permitted.<sup>21</sup> This system has proven woefully inadequate.

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ZATION FOR ECONOMIC COOPERATION DEVELOPMENT MODEL INCOME TAX TREATIES AND COMMENTARIES: A COMPARATIVE PRESENTATION, at v-xxxii (1987); Org. for Econ. Cooperation & Dev., Model Convention with Respect to Taxes on Income and on Capital art. 26 (2005) [hereinafter OECD 2005 Model Convention], available at <http://www.oecd.org/dataoecd/50/49/35363840.pdf>.

<sup>17</sup> See *infra* notes 138–167 and accompanying text.

<sup>18</sup> The Organization for Economic Cooperation and Development ("OECD") drew attention to the problem posed by the new global environment with its 1998 report on tax competition. ORG. FOR ECON. COOPERATION & DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 66 (1998) [hereinafter 1998 OECD REPORT], available at <http://www.oecd.org/dataoecd/33/0/1904176.pdf> (recognizing that although globalization and new technologies have brought about prosperity, the new global environment raises "challenges for governments to minimi[z]e tax induced distortions in investment and financing decisions and to maintain their tax base"). Considering this and other factors, the OECD Council recommended continued adoption of tax information exchange. *Id.* at 65–69.

<sup>19</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>20</sup> See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26. On a far smaller scale, these arrangements resemble an agreement between neighbors to water each other's plants whenever one neighbor is away from home. Although it is not impossible for such an arrangement to work, it would work best when both neighbors have plants and both travel. Without a reasonable degree of symmetry, it may not be possible to strike a mutually satisfactory reciprocal barter arrangement, and plants may go thirsty.

<sup>21</sup> The use of cash consideration is outside the scheme under the current bilateral agreements, which call for mandatory delivery upon request of pertinent information. See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26. An express prohibition against the use of cash consideration was part of the original League of Nations model. 1927 Report, *supra* note 16, at 40.

The roots of today's extraterritorial tax information acquisition system can be traced back to the earliest days of the international tax regime and the foundational 1927 League of Nations report on international taxation.<sup>22</sup> Crafted to meet the needs of an era in which international transactions and the income tax itself played far more limited roles,<sup>23</sup> the barter system has fallen short in two very different respects. It simultaneously works both too well and not well enough.

On the one hand, because the barter system represents a market in which national governments trade "'bulk' taxpayer information"<sup>24</sup> with respect to individuals and businesses engaging in cross-border activities, it raises important privacy concerns.<sup>25</sup> As international commerce and investment has grown in importance, the threat to privacy posed by these exchanges has grown alongside them.<sup>26</sup> Information exchange now affects a far broader segment of the population than during the first half of the twentieth century.<sup>27</sup> The volume of information about private parties that changes hands between governments pursuant to information exchange can be immense.<sup>28</sup> In this sense, by compiling so much potentially sensitive information, the system works too well.

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<sup>22</sup> See *infra* notes 216–244 and accompanying text.

<sup>23</sup> See W. ELLIOT BROWNLEE, *FEDERAL TAXATION IN AMERICA: A SHORT HISTORY* 86, 96–97 (1996) (noting that the tax system that emerged out of World War II has remained the core of federal finance since that time and noting the growth in the tax base under the new "mass taxation" system). Tax collection through withholding of payroll taxes also entered the system at this time. See *id.* at 94–96.

<sup>24</sup> See ORG. FOR ECON. COOPERATION & DEV., COMM. ON FISCAL AFFAIRS, *MANUAL ON THE IMPLEMENTATION OF EXCHANGE OF INFORMATION PROVISIONS FOR TAX PURPOSES, MODULE 3 ON AUTOMATIC (OR ROUTINE) EXCHANGE OF INFORMATION* ¶¶ 1–4 (2006) [hereinafter *OECD MANUAL*] (describing automatic information exchange and citing sources of law for countries' automatic exchange of information).

<sup>25</sup> See Cynthia Blum, *Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?*, 6 *FLA. TAX REV.* 579, 602–33 (2004). Those privacy concerns are both a function of the types of data that are exchanged (including social security numbers) and the increased risk of data security breaches that occur when data is aggregated and commodified. See generally Paul M. Schwartz & Edward J. Janger, *Notification of Data Security Breaches*, 105 *MICH. L. REV.* 913 (2007) (considering efficacy of existing regulatory regime for notification of data security breaches).

<sup>26</sup> See Blum, *supra* note 25, at 623–33 (discussing privacy concerns particularly relevant to extraterritorial tax information).

<sup>27</sup> See BROWNLEE, *supra* note 23, at 96–97.

<sup>28</sup> The standard OECD electronic information exchange format allows for as many as 104 items of information about each taxpayer and his or her income. See *OECD MANUAL*, *supra* note 24, at 8.

On the other hand, because by design the market for information is incomplete,<sup>29</sup> potentially beneficial transactions often do not take place. The market is incomplete in a number of respects: because it is a barter market<sup>30</sup> and because, with few exceptions, for most potential transactions the only available product is raw tax data.<sup>31</sup> In their roles as purchasers, countries have virtually no flexibility regarding the consideration they may use to acquire extraterritorial tax information.<sup>32</sup> As sellers, they are permitted little choice as to the types of information they may offer.<sup>33</sup> To take a simple example, if extraterritorial tax information is the only currency a country were permitted to use to acquire extraterritorial tax information, how could it be enough for countries that are, or would like to be, net importers of tax information?

For national governments, the choice is not whether to address the growing extraterritorial tax information deficit, but how.<sup>34</sup> In prior work, I have argued that wealthy, information-dependent countries such as the United States could gain better access to tax information by paying other countries, specifically tax havens, for that access.<sup>35</sup> This Article takes as its premise that even if every country traditionally viewed as a tax haven were to disappear overnight, the extraterritorial tax information deficit would be large and growing. It considers whether a more complete market for extraterritorial tax information

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<sup>29</sup> An incomplete market "[e]xist[s] when certain goods—commodities, as well as financial assets, insurance, and credit—cannot be contracted for, or only partially so." *DICTIONARY OF THE SOCIAL SCIENCES* 226 (Craig Calhoun ed., 2002).

<sup>30</sup> A "barter" system is a "system of exchange whereby goods or services are exchanged without the use of money." *Id.* at 33. Barter systems are "cumbersome and inefficient": in these systems "not all trades that are desired will be realized . . . result[ing] in market inefficiencies." *Id.* In a barter system, the scope for trade is thus limited to transactions in which there is a "double coincidence of wants." *See id.*

<sup>31</sup> *See, e.g.*, U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>32</sup> *See, e.g.*, U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26 (discussing early disallowance of cash consideration for tax information) OECD 2005 Model Convention, *supra* note 16, art. 26. This observation applies where there is an agreement. In some instances, other policy incentives have served as consideration for information exchange. *See* Blum, *supra* note 25, at 631–32 & n.172 (observing that the "one-sided" agreement between the United States and the Bahamas provided the United States with tax information and the Bahamas with preferential tax treatment for conventions held there).

<sup>33</sup> The prohibition is implied by the express agreement to exchange only information. *See, e.g.*, U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>34</sup> *See* Tillinghast, *supra* note 8, at 39.

<sup>35</sup> Steven Dean, *Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation*, 58 *HASTINGS L.J.* 911, 957 (2007).

could enhance the availability of extraterritorial tax information more broadly and improve countries' ability to enforce their taxes, in part by giving them access to ex ante extraterritorial tax information that is tailored to their unique needs.<sup>36</sup>

Today's information exchange system embraces an outdated, one-size-fits-all approach.<sup>37</sup> Grounded in the pre-World War II tax structure, this exchange system has existed largely unchanged for the better part of a century as the world has changed around it.<sup>38</sup> A more complete market for extraterritorial tax information, by contrast, would impose fewer constraints on market participants. It might, for example, sanction the use of cash consideration and the acquisition of ex ante information other than the lists of homogenized "bulk" tax data that have been the subject of information exchange agreements since the 1920s.<sup>39</sup> Such a market could allow a government that wishes to be an importer of extraterritorial tax information to acquire information carefully specified to maximize its utility and to minimize its impact on privacy, and to do so even if it has little or no tax information to "sell." Likewise, information exporters could establish the terms under, and the form in, which they are willing to supply that information. Modern information technology, a key factor in the emergence of a variety of innovative markets for information in recent years,<sup>40</sup> would allow governments to produce and acquire extraterritorial tax information that is both timely and tailored to the requirements of a given tax regime.

Replacing the rudimentary global market for extraterritorial tax information with a more complete market would provide governments with improved access to critical information. At the same time, that transformation could provide other important benefits, including greater transparency and improved privacy protections. By structuring the market in a way that compels governments to be open about the items of information that they buy and sell, and about the prices at which it changes hands, voters would know precisely what information their governments are selling and would also be able to ensure that the market price of that information reflects the true costs of selling it.

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<sup>36</sup> See *infra* notes 337–411 and accompanying text (considering proposals to remedy the incomplete market for extraterritorial tax information).

<sup>37</sup> See *infra* notes 318–336 and accompanying text (describing failure of barter system to supply sufficient extraterritorial tax information).

<sup>38</sup> See *infra* notes 206–317 and accompanying text (describing historical development of the current information barter system).

<sup>39</sup> See *infra* notes 345–359 and accompanying text (proposing solution for more complete market for tax information).

<sup>40</sup> See Schwartz, *supra* note 1, at 2057.



Of course, even if a more complete market might be an improvement, it may be that the optimal solution is not more market, but less. One alternative to creating a more complete market would be to replace the existing market with a cooperative intergovernmental arrangement designed to facilitate the cross-border flow of extraterritorial tax information, perhaps in a manner consistent with more robust privacy protections than a market might provide.<sup>41</sup> Another would be to make the market irrelevant by consciously reducing the demand for extraterritorial tax information by redesigning national tax systems.<sup>42</sup> Any of those three approaches could strike a better balance between privacy and enforcement than the current information barter system.<sup>43</sup>

Part I of the Article describes the critical role information plays in modern tax systems.<sup>44</sup> It first draws a distinction between *ex ante* and *ex post* tax information and then explains their importance in facilitating observation and investigation, respectively. Part II then considers the increasing importance of extraterritorial tax information and the limits on countries' ability to gather that information unilaterally.<sup>45</sup> Part III describes the creation and the evolution of the market for extraterritorial tax information over the course of the twentieth century.<sup>46</sup> Part IV considers the implications of two possible paths forward: (1) creating a more complete market, or (2) eliminating the need for a market by creating a nonmarket supranational tax infrastructure or by reducing the consumption of extraterritorial tax information.<sup>47</sup>

## I. INFORMATION AND THE U.S. INCOME TAX

The U.S. income tax is a voracious consumer of information.<sup>48</sup> In part, that is because there are few meaningful limits on the ability of tax authorities to gather information, at least from within the United States.<sup>49</sup> Perhaps the most important constraint is the willingness of tax

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<sup>41</sup> See *infra* notes 362–370 and accompanying text.

<sup>42</sup> See *infra* notes 371–377 and accompanying text.

<sup>43</sup> See *infra* notes 378–411 and accompanying text.

<sup>44</sup> See *infra* notes 48–130 and accompanying text.

<sup>45</sup> See *infra* notes 131–205 and accompanying text.

<sup>46</sup> See *infra* notes 206–336 and accompanying text.

<sup>47</sup> See *infra* notes 337–411 and accompanying text.

<sup>48</sup> See Blum, *supra* note 25, at 623 (noting that the structure of the U.S. income tax requires a variety of information disclosures to the IRS).

<sup>49</sup> See, e.g., I.R.C. §§ 6041–6042, 6111 (2000 & Supp. V 2005) (requiring various types of third-party reporting); I.R.C. §§ 7601–7613 (West 2002 & Supp. 2007) (authorizing investigative and enforcement powers of IRS including summons and power to execute search and arrest warrants, among others); Treas. Reg. § 1.6011-1 (as amended in 1967),

authorities to ask for it: in some situations, privacy<sup>50</sup> or other policy concerns<sup>51</sup> prevent authorities from demanding certain types of information from or about taxpayers. Because they do not pay for the information they collect,<sup>52</sup> the principal challenge for U.S. tax authorities is engineering a system capable of gathering a vast amount of raw data and extracting useful information from that data.<sup>53</sup>

This Part considers the ways in which U.S. tax authorities collect and use information.<sup>54</sup> The first Section illustrates the importance of information by exploring its use in two contexts: the taxation of original issue discount ("OID") and the federal government's ongoing battle against tax shelters.<sup>55</sup> In each case, the government relies on information provided by third parties about taxpayers' activities to

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1.6012-1 (1960); Temp. Treas. Reg. § 1.6012-2T (2006) (requiring individual and corporate income tax returns); U.S. Dep't of Justice, Tax Division, About Us, [http://www.usdoj.gov/tax/about\\_us.htm](http://www.usdoj.gov/tax/about_us.htm) (last visited Feb. 28, 2008) [hereinafter DOJ, About Us] (describing federal criminal tax enforcement program).

<sup>50</sup> The nontaxation of certain intrafamilial and other intimate "transactions" is at least partly a function of the unwillingness of the IRS to ask the sorts of difficult questions that might allow it to distinguish between those that should produce tax consequences and those that should not. See *United States v. Harris*, 942 F.2d 1125, 1131-33 (7th Cir. 1991) (addressing difficulty of characterizing transfers within intimate relationships when transfers are neither purely motivated by generosity (and thus nontaxable) nor are simply compensation for prostitution (clearly taxable)).

<sup>51</sup> Unrealized appreciation, including capital gains, is not taxed each year and is instead taxed when the appreciated property is sold or exchanged. See *Eisner v. Macomber*, 252 U.S. 189, 214-15 (1920) (concluding that "enrichment through increase in value of capital investment is not income"). Part of the rationale for refraining from taxing capital gains on a mark-to-market basis (i.e., taxing each year's capital gains as they accrue) is the difficulty of measuring gain or loss in the absence of a market transaction. See David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113-14 (1986) (noting liquidity and valuation problems as most key arguments against "accrual" taxation). But that argument is weakened when accurate asset pricing information is widely and cheaply available. See *id.* at 1132-33 (noting that the information needed to impose current, "accrual" taxation on income from publicly traded securities is readily available). For example, refraining from taxing capital gains from publicly traded stock because of concerns about access to pricing information would be unreasonable. See *id.*

<sup>52</sup> See JOEL SLEMMOD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM* 134 (2d ed. 2000) (discussing the costs imposed on private parties in complying with information reporting requirements).

<sup>53</sup> The recent proposal to require third party reporting of taxpayers' "basis" in certain securities illustrates the magnitude of the challenge. See STAFF OF J. COMM. ON TAXATION, 109TH CONG., *ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE* 1-10 (Com. Print. 2006), available at <http://www.finance.senate.gov/press/Gpress/2005/prg101906.pdf>. The proposal is simple, but the complexity of the rules governing tax basis and the vast amount of data involved could make the implementation extremely difficult. See *id.* at 9-10 (discussing challenges which would be involved in IRS administration of the proposal).

<sup>54</sup> See *infra* notes 59-130 and accompanying text.

<sup>55</sup> See *infra* notes 59-85 and accompanying text.

supplement information reported by taxpayers themselves.<sup>56</sup> The following Section draws a distinction between observation and investigation, the two ways tax authorities use that information.<sup>57</sup> Observation uses *ex ante* information to identify possible wrongdoing, while investigation primarily relies on *ex post* information to serve as evidence of wrongdoing. The third Section weighs the costs and benefits of acquiring tax information.<sup>58</sup>

### A. Tax Information

The information that tax authorities need to keep the income tax running smoothly defies easy categorization. Often that information bears no resemblance to the universally recognizable, and easily verifiable, facts a typical individual might report on his or her tax return. Along with information about salaries<sup>59</sup> received and cash dividends<sup>60</sup> paid, U.S. tax authorities receive a steady stream of updates regarding more arcane items such as OID<sup>61</sup> and "reportable transactions."<sup>62</sup> In some respects, these two streams of information are typical examples of the information U.S. tax authorities receive. For instance, they pertain to the activities of particular taxpayers and provide authorities with a sort of "early warning system" for potential compliance failures.<sup>63</sup> At the same time, they illustrate the idiosyncrasies that permeate U.S. tax rules, and therefore, the idiosyncratic information needed to enforce them.

## 1. OID Reporting

In a sense, idiosyncrasies are an unavoidable byproduct of the sophistication of the U.S. income tax. Creating a system of rules that attempts to ensure that tax liabilities reflect taxpayers' true economic gains and losses represents an enormous challenge. Often, the difficulty lies in reconciling nonprototypical transactions with a regime designed with more conventional activity in mind. In a simple world

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<sup>56</sup> See *infra* notes 59–85 and accompanying text.

<sup>57</sup> See *infra* notes 86–117 and accompanying text.

<sup>58</sup> See *infra* notes 118–130 and accompanying text.

<sup>59</sup> I.R.C. § 6041 (2000 & Supp. V 2005).

<sup>60</sup> I.R.C. § 6042 (2000).

<sup>61</sup> See, e.g., Treas. Reg. § 1.1275-3 (as amended in 1996) (imposing reporting obligations on issuers of OID debt instruments).

<sup>62</sup> See Treas. Reg. § 1.6011-4 (as amended in 2006) (defining "reportable transaction" and describing reporting requirement).

<sup>63</sup> See *id.*; Treas. Reg. § 1.1275-3 (as amended in 1996).

in which annual economic income and losses could be measured by cash flows, enforcing an income tax would pose few challenges. When transactions fail to fit neatly into that mold, the task becomes more difficult, and tax rules can become complex. The OID rules, which deem debt instruments with infrequent or irregular interest payment schedules to pay interest at a steady annual rate, offer a relatively straightforward example of this phenomenon.<sup>64</sup>

The OID regime is complicated, but its purpose is simple.<sup>65</sup> Most taxpayers are only taxed on interest in the year that interest is paid.<sup>66</sup> This system works fairly well when interest is paid steadily on a quarterly or annual basis. Unfortunately, the concepts of debt and interest are extremely flexible, so it is not difficult to create an unconventional equivalent that provides lenders with identical economic returns but with very different cash flows.<sup>67</sup>

In essence, the OID rules require holders of debt instruments with nonprototypical payment schedules to pay tax each year on the basis of a series of hypothetical interest payments reflecting the amount of economic income earned in each year.<sup>68</sup> As a theoretical matter, it is hard to find fault with this system. It poses obvious practical problems, however, for tax authorities. Keeping track of those hypothetical payments is no small task even when transactions involve a single borrower and a single lender. A challenging task becomes that

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<sup>64</sup> See I.R.C. §§ 1271–1275 (2000).

<sup>65</sup> See Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. Rev. 79, 90–91 (2002) (noting that before the OID rules, taxpayers received a significant deferral opportunity).

<sup>66</sup> See I.R.C. § 451(a) (2000).

<sup>67</sup> See *United States v. Midland-Ross Corp.*, 381 U.S. 54, 58 (1965) (noting that “\$6 earned on a one-year note for \$106 issued for \$100 is precisely like the \$6 earned on a one-year loan of \$100 at 6% stated interest” and concluding that both should receive the same tax treatment). For example, a bank certificate of deposit (“CD”) that provides for a single payment to the purchaser/lender after five years can easily be structured to provide the same economic yield as a loan with a similar term that provides for annual interest payments. Without the OID rules, the tax treatment of the two debt instruments would be very different. See I.R.C. §§ 1271–1275; Ring, *supra* note 65, at 90–91 (discussing purpose behind OID rules when first enacted in 1969). The lender receiving current interest payments would be taxed each year while the purchaser of the CD would only be required to pay tax in the fifth year. See Ring, *supra* note 65, at 90–91. Without the OID rules, the resulting tax deferral could represent a valuable tax benefit to the holder of the CD. See *id.* Because many payors of interest, including banks that might issue such a CD, deduct interest currently even when it is not paid currently, that deferral would often represent a net loss to the government. See *id.*

<sup>68</sup> See I.R.C. § 1272.

much more difficult when the debt instrument is a publicly traded bond rather than a bank deposit.

To give tax authorities a way of monitoring taxpayers' voluntary compliance with the OID rules, the issuers of OID instruments and certain intermediaries are required to submit a variety of contemporaneous reports to the government.<sup>69</sup> Upon the issuance of the debt instrument, the borrower must provide the government with information describing the characteristics of the debt instrument.<sup>70</sup> In addition, each year reports must be filed identifying each "recipient" of phantom OID income.<sup>71</sup> By matching the amounts of OID income reported by taxpayers against the information provided by those third parties, tax authorities can easily identify cases in which taxpayers have failed to report the "receipt" of this hypothetical income.<sup>72</sup> Without access to that contemporaneous information, tax authorities would only be able to uncover OID underreporting through audits of particular taxpayers.

## 2. Tax Shelter Reporting

The OID reporting rules described above are only one of a number of interrelated, longstanding reporting regimes.<sup>73</sup> One relatively new reporting requirement applies to transactions that exhibit characteristics common to tax shelters.<sup>74</sup> This new requirement attempts to give tax authorities a means of identifying potential tax shelters among the many ordinary transactions reported by taxpayers each year.<sup>75</sup> For tax authorities, identifying tax shelters among all of the ordinary transactions is not quite like searching for a needle in a haystack, but there

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<sup>69</sup> I.R.C. § 6049 (West 2002 & Supp. 2007) (imposing reporting requirements on interest payors and payees, including regarding OID obligations); Treas. Reg. § 1.1275-3 (as amended in 1996) (imposing reporting requirements on issuers of publicly traded OID debt instruments).

<sup>70</sup> Treas. Reg. § 1.1275-3.

<sup>71</sup> I.R.C. § 6049(d) (6).

<sup>72</sup> It should be noted that the amount of OID reported is often imprecise. See I.R.S. Pub. No. 550, at 19 (2007). Because these debt instruments may generally be bought and sold, the reporting regime may misidentify the recipient of the OID or fail to take into account relevant adjustments. See *id.* Taxpayers are required to make any necessary adjustments to the reported amounts. *Id.*

<sup>73</sup> See I.R.C. § 6049. The modern third-party information-reporting regime was introduced in 1917. War Revenue Act, Pub. L. No. 65-50, § 1211, 40 Stat. 300, 325 (1917).

<sup>74</sup> Treas. Reg. § 1.6011-4(b) (as amended in 2006) (identifying six categories of transactions that must be reported as potential tax shelters). One of the six categories, transactions with a significant book/tax disparity, was subsequently eliminated. I.R.S. Notice 2006-6, 2006-5 I.R.B. 385.

<sup>75</sup> Raskolnikov, *supra* note 8, at 585-86.

are similarities.<sup>76</sup> Tax authorities face long odds in discovering abusive tax shelters using a "brute force" approach. The "reportable transaction" requirements represent an effort to provide authorities with what could be thought of as smart<sup>77</sup> information that allows them to target transactions that are especially likely to be tax shelters.<sup>78</sup>

For example, the reportable transaction regulations initially required taxpayers and their advisors<sup>79</sup> to report any transaction in which the book and the tax results differed significantly.<sup>80</sup> This requirement relied on the insight that taxpayers face different incentives with respect to their accounting and tax results.<sup>81</sup> Because managers typically prefer to report optimistic results for book purposes while understating their successes for tax purposes, significant gaps between the two may indicate that managers are using tax shelters to cut a business's tax liability.<sup>82</sup> Another rule requires taxpayers to disclose their participation in transactions that are "confidential"<sup>83</sup> as potential tax shelters. Both approaches attempt to bolster the anti-tax-shelter effort by providing tax authorities with information that is not merely correct and complete but that is, above all else, useful.

Particularly when compared to the longstanding system for exchange of extraterritorial tax information, both the OID reporting

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<sup>76</sup> See *id.*

<sup>77</sup> In essence, tax authorities outsource some of their work to taxpayers. Rather than collecting tax data and determining whether a transaction falls into one of the specified categories, taxpayers must instead conduct the necessary analysis. See Treas. Reg. § 1.6011-4(b).

<sup>78</sup> See *id.*; Raskolnikov, *supra* note 8, at 585–86.

<sup>79</sup> The tax shelter rules require third parties classified as "material advisors" to alert authorities to the existence of reportable transactions. See I.R.C. § 6111 (Supp. V 2005).

<sup>80</sup> Treas. Reg. § 1.6011-4(b)(6). Eventually, that reporting requirement was subsumed into the broader annual Schedule M-3 reporting requirement. See John Keenan et al., *Tax Shelters—Reportable Transaction Disclosure Regulations Continue to Evolve*, 59 Daily Tax Rep. (BNA) No. 59, at 1 (Mar. 28, 2007); *supra* notes 18–19 and accompanying text.

<sup>81</sup> See David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927, 972, 990 (2007) (noting managers may face incentives to inflate income for accounting purposes even at the cost of increasing the firm's tax bill).

<sup>82</sup> See U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 14 (1999), available at <http://www.treas.gov/offices/tax-policy/library/ctswhite.pdf>. This intuition that a growing book-tax gap indicates expansion of tax shelters has come under attack over the past few years. See Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal* 3 & n.3 (N.Y. Univ. Sch. of Law, NYU Ctr. for Law, Econ. & Org., Law & Econ. Research Paper Series, Working Paper No. 07-38, 2007), available at <http://ssrn.com/abstract=1017073> (noting disagreement over the exact causes of the book-tax gap).

<sup>83</sup> Treas. Reg. § 1.6011-4(b)(3) (as amended in 2006).

rules and the reportable transaction requirements are relatively new.<sup>84</sup> They each were created in response to specific needs and carefully designed to ensure that the information they generated would be responsive to those needs.<sup>85</sup> As a result, they constitute more than simple compilations of readily available information. Thus, they illustrate the specificity of the information needed to ensure compliance with a complex income tax system.

### B. Observation and Investigation

The reporting requirements described above illustrate two key features of the system U.S. tax authorities use to gather information about taxpayers. First, it requires third parties to generate and report a significant amount of information regarding taxpayers and their activities.<sup>86</sup> Second, it often requires that information be reported automatically and contemporaneously with the payments or the transaction triggering the reporting obligation.<sup>87</sup>

Although important, those *ex ante* information reporting requirements are not the only method tax authorities employ to monitor taxpayers. This Section draws a distinction between the two principal techniques tax authorities employ to ensure taxpayer compliance: observation and investigation.<sup>88</sup> The two information acquisition techniques described above illustrate the power of observation, which allows tax authorities to identify potential compliance failures among a large number of transactions and taxpayers. Observation relies on *ex ante* information reporting requirements to make it possible for authorities to spot noncompliance without taking any affirmative measures to collect information about specific taxpayers or their activities.<sup>89</sup>

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<sup>84</sup> Compare 1927 Report, *supra* note 16, at 22–23 (containing early tax information exchange provisions), with I.R.C. § 6049 (West Supp. 2007), and Treas. Reg. § 1.6011-4(b).

<sup>85</sup> See Treas. Reg. § 1.1275-3 (as amended in 1996) (imposing reporting obligations on issuers of OID debt instruments); Treas. Reg. § 1.6011-4(b).

<sup>86</sup> Both the OID and tax shelter rules discussed above rely heavily on third-party reporting. See I.R.C. § 6049; I.R.C. § 6111 (Supp. V 2005); Treas. Reg. § 1.6011-4(b).

<sup>87</sup> See, e.g., I.R.C. § 6049.

<sup>88</sup> See *infra* notes 89–117 and accompanying text.

<sup>89</sup> See, e.g., Treas. Reg. § 1.6011-4(b)(2) to -4(b)(7).

Investigation plays a different role.<sup>90</sup> While *ex ante* information acquisition techniques provide authorities with a great breadth of information, they are no substitute for *ex post* information acquisition techniques. By focusing on a specific taxpayer or transaction, perhaps identified as potentially aberrant through observation, tax authorities can use their investigatory powers to assemble a picture of a taxpayer's behavior with the depth necessary to prove and, if necessary, prosecute taxpayer noncompliance.<sup>91</sup>

## 1. Ex Ante Information Reporting Requirements

U.S. tax authorities require a wide range of individuals and entities to report an array of payments, transactions, and events.<sup>92</sup> In the first instance, individuals, corporations, estates, and others are obligated to file tax returns describing their own status and activities each year.<sup>93</sup> In addition, third parties doing business with or providing services to those taxpayers are required to provide information that is used to supplement and verify that self-reported information.<sup>94</sup>

Information reporting regimes similar to the OID rules described above apply to a range of more common income items, including wages<sup>95</sup> and dividends.<sup>96</sup> As a result, the information that employees and investors receive on the familiar Internal Revenue Service ("IRS") Forms W-2 and 1099 provided by employers and financial institutions

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<sup>90</sup> The relationship between *ex ante* and *ex post* information is not precisely the same as that between observation and investigation. Authorities may choose to use *ex post* information, information collected after an event or transaction has taken place, simply to check on taxpayers' compliance. Alternatively, authorities may find information they collect automatically and contemporaneously to be useful during the course of an investigation. Nevertheless, as a general matter, *ex ante* information is best suited to observation whereas *ex post* information lends itself to investigation.

<sup>91</sup> See I.R.C. §§ 7601-7613 (West 2002 & Supp. 2007) (authorizing investigative and enforcement powers of IRS including summons and power to execute search and arrest warrants, among others); DOJ, About Us, *supra* note 49 (describing federal criminal tax enforcement program).

<sup>92</sup> See, e.g., I.R.C. §§ 6041-6042, 6111 (2000 & Supp. V 2005); Treas. Reg. §§ 1.6011-1 (as amended in 1967), 1.6012-1 (1960); Temp. Treas. Reg. § 1.6012-2T (2006) (requiring individual and corporate income tax returns).

<sup>93</sup> See, e.g., Treas. Reg. §§ 1.6011-1, 1.6012-1; Temp. Treas. Reg. § 1.6012-2T (requiring individual and corporate income tax returns).

<sup>94</sup> See, e.g., I.R.C. §§ 6041-6042, 6111; Lederman, *supra* note 7, at 697-99.

<sup>95</sup> I.R.C. § 6041.

<sup>96</sup> I.R.C. § 6042.



every year is also reported directly to tax authorities.<sup>97</sup> Because that information is reported along with taxpayers' social security numbers (or taxpayer identification numbers ("TINs")), it would be a relatively simple matter for the government to determine the tax liability for many individual taxpayers even if no return is filed.<sup>98</sup>

Observation serves two interrelated purposes: (1) affirmatively discouraging noncompliance by (2) allowing authorities to identify noncompliance.<sup>99</sup> When third-party information capable of verifying that reported by taxpayers is not available from employers, financial institutions, or other intermediaries, self-reporting becomes far less reliable.<sup>100</sup> On the one hand, if taxpayers believe that the government has been notified that they have received payments that almost certainly represent items of taxable income, taxpayers have little to gain by failing to report those amounts.<sup>101</sup> On the other hand, a taxpayer confident that the government has no way of knowing that she has received income may only have her conscience to contend with if she fails to report it.<sup>102</sup> As a result, by encouraging compliance, *ex ante* information

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<sup>97</sup> See I.R.C. §§ 6041–6042; I.R.S. Form W-2, Wage & Tax Statement (2008), available at <http://www.irs.gov/pub/irs-pdf/fw2.pdf>; I.R.S. General Instructions for Forms 1099, 1098, 5498 & W-2G, at 8 (2007), available at <http://www.irs.gov/pub/irs-pdf/i1099gi.pdf>.

<sup>98</sup> See, e.g., I.R.C. §§ 6039G, 6050I, 6050L, 6050P (2000 & Supp. V 2005) (requiring disclosure of TINs as a component of reporting particular transactions). California has actually begun limited use of a "ReadyReturn" that uses information provided by employers to prepare a completed tax return that taxpayers can simply review and approve over the internet. See State of Cal. Franchise Tax Bd., Frequently Asked Questions About ReadyReturn, [http://www.ftb.ca.gov/readyReturn/faq\\_about.shtml](http://www.ftb.ca.gov/readyReturn/faq_about.shtml) (last visited Feb. 28, 2008).

<sup>99</sup> The same basic principle, using visibility to ensure voluntary compliance, applies to information reporting and to Foucault's panopticon. MICHEL FOUCAULT, DISCIPLINE AND PUNISH 201–02 (Alan Sheridan trans., Vintage Books 2d ed. 1995) (1977) (describing use of surveillance that is at once "[v]isible" and "[u]nverifiable" to ensure that "it is not necessary to use force to constrain the convict to good behaviour, the madman to calm, the worker to work, the schoolboy to application, the patient to the observation of the regulations"). Likewise, when taxpayers are aware that certain types of income are subject to third-party information reporting there is generally no need for tax authorities to enforce compliance.

<sup>100</sup> See Lederman, *supra* note 7, 698 & n.13 (noting that income reporting compliance falls from above ninety percent to below fifty percent when third-party information reporting is unavailable).

<sup>101</sup> See *id.* Wages paid by a domestic employer are the quintessential example of such payments. See *id.* The successful prosecution of Richard Hatch for tax evasion for failing to report his one million dollar "Survivor" prize provides a colorful illustration of the futility of failing to report income that will come to the government's attention through other channels. See Pam Belluck, *A New Reality for First "Survivor" Winner: Tax Evasion Trial*, N.Y. TIMES, Jan. 22, 2006, at 16; "Survivor" Hatch Guilty of Tax Evasion, CBSNEWS.COM, Jan. 25, 2006, <http://www.cbsnews.com/stories/2006/01/25/entertainment/main1237996.shtml>.

<sup>102</sup> See Raskolnikov, *supra* note 8, at 578 (discussing potential influence of cultural traditions and social norms on taxpayer compliance). The classic case in which taxpayers

reporting requirements not only help authorities to correct taxpayer omissions but also limit the need to make such corrections.<sup>103</sup>

## 2. Ex Post Information Acquisition

If sufficiently comprehensive, observation could virtually eliminate noncompliance.<sup>104</sup> Unfortunately, despite tax authorities' best efforts, both garden-variety underreporting and tax fraud remain significant problems.<sup>105</sup> To pursue suspected tax cheats, tax authorities rely on different sorts of information gathering techniques than they use to observe taxpayers.<sup>106</sup> Rather than attempting to anticipate the information they need to monitor compliance, tax authorities collect information on an as-needed basis; they determine the source and the nature of the information required in each circumstance.<sup>107</sup> Some of those investigative techniques, such as the use of grand juries and search warrants, are no different than those employed in other contexts.<sup>108</sup> Others, like the IRS's power to compel the production of information by issuing an administrative summons, are more unique.<sup>109</sup>

Pursuant to its administrative summons power, the IRS has broad authority to investigate potential wrongdoing by collecting information with respect to the activities of a particular taxpayer.<sup>110</sup> This power allows the IRS great latitude to engage in "fishing expeditions" based on

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discovered a large amount of cash in a used piano provides an example of a situation in which authorities have no way to verify self-reported amounts. See *Cesarini v. United States*, 296 F. Supp. 3, 4 (N.D. Ohio 1969). In practice, income earned by small, cash-based businesses is prone to this kind of underreporting. See Lederman, *supra* note 7, at 698 n.12; Raskolnikov, *supra* note 8, at 575.

<sup>103</sup> See Lederman, *supra* note 7, at 698 n.12.

<sup>104</sup> See SLEMROD & BAKIJA, *supra* note 52, at 160–61 (noting that the IRS must monitor and investigate taxpayers whose incomes are not subject to information reporting, and that tax enforcement becomes easier where withholding and information reporting are available); Lederman, *supra* note 7, at 698 (noting increased compliance in areas with third-party reporting compared with areas in which third-party information reporting is not available).

<sup>105</sup> See Sawicky, *supra* note 6, at 6 (estimating components of the tax gap).

<sup>106</sup> See, e.g., I.R.C. §§ 7601–7613 (West 2002 & Supp. 2007) (authorizing investigative and enforcement powers of IRS including summons and power to execute search and arrest warrants, among others).

<sup>107</sup> See *id.*

<sup>108</sup> See, e.g., I.R.C. § 7608 (authorizing internal revenue officers to execute and serve search warrants and arrest warrants).

<sup>109</sup> See I.R.C. § 7602(a).

<sup>110</sup> See *id.*

nothing more than a suspicion that the law may have been violated.<sup>111</sup> The IRS has the power to issue a summons either to the taxpayer that is the subject of the inquiry or to a third party in possession of information about the taxpayer.<sup>112</sup>

The only significant limit on the IRS's summons power applies when the investigation changes from an administrative inquiry to a criminal prosecution.<sup>113</sup> When the IRS refers a case to the Justice Department for prosecution, the IRS loses the power to issue an administrative summons.<sup>114</sup> After a referral, the Justice Department may continue to investigate broadly but must do so through a grand jury.<sup>115</sup> Of course, the prosecutors of tax crimes, including attorneys from the Criminal Enforcement Sections of the Justice Department's Tax Division and Assistant U.S. Attorneys,<sup>116</sup> have all the powers ordinarily wielded in criminal cases.

The government's capacity to gather ex post information is undoubtedly an important complement to the ex ante information reporting regime. The power to investigate, however, is no substitute for the power to observe.<sup>117</sup> Together, they provide tax authorities with a powerful combination of depth and breadth of information that allows them both to discourage and punish noncompliance.

### C. *Balancing Benefits and Costs of Acquiring Tax Information*

The compliance and enforcement benefits of providing tax authorities with access to ex post and, in particular, ex ante<sup>118</sup> tax information are obvious. The costs of providing authorities with that access

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<sup>111</sup> *United States v. Morton Salt Co.*, 338 U.S. 632, 641-43 (1950); *accord* *United States v. Luther*, 481 F.2d 429, 432 (9th Cir. 1973) ("Sec. 7602 authorizes the Secretary or his delegate 'to fish.'").

<sup>112</sup> The IRS must generally notify the subject of the investigation that it may issue third-party summonses and must also notify taxpayers within three days after the issuance of a third-party summons. *See* I.R.C. §§ 7602(c), 7609(a).

<sup>113</sup> *See* I.R.C. § 7602(d).

<sup>114</sup> *See id.*

<sup>115</sup> *See id.*; *see also* *Morton Salt*, 338 U.S. at 642 (likening the administrative summons power to a grand jury's broad investigative authority).

<sup>116</sup> *See* DOJ, *About Us*, *supra* note 49 (describing federal criminal tax enforcement program).

<sup>117</sup> *See* Lederman, *supra* note 7, at 697-98. Importantly, technology allows authorities to leverage their observational capacity by collecting and analyzing ever greater amounts of information. *See* OECD MANUAL, *supra* note 24, at 8 (allowing for as many as 104 items of information about each taxpayer in standard OECD electronic information exchange format). Investigation lends itself less well to automation.

<sup>118</sup> Because it encourages greater compliance and provides authorities with a low-cost means of spotting noncompliance, ex ante information is especially important.

tend to be less apparent.<sup>119</sup> In part, that is because the duty to supply tax information is imposed on an extremely broad class of individuals and entities, and the costs of supplying that information are dispersed even more broadly.<sup>120</sup> That said, the costs of supplying tax information to the government are not insignificant.<sup>121</sup>

In the domestic context, it would not be entirely unreasonable to assume that the amount of information that is acquired by tax authorities produces benefits that are comparable to the costs they impose.<sup>122</sup> A smoothly functioning political process would tend to create that rough parity.<sup>123</sup> If the public perceived the costs of information reporting to be higher than its benefits, government actors would have an incentive to reduce those costs by limiting the amount of information

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<sup>119</sup> The IRS budget is also much easier to quantify than the costs taxpayers and other third parties incur. See SLEMROD & BARIJA, *supra* note 52, at 136 (noting the difficulty of estimating business tax compliance costs).

<sup>120</sup> See *id.* at 134 (noting that the total compliance costs paid by taxpayers and third parties dwarf the IRS's budget). Because nearly all employers are required to report the amount of wages paid, see I.R.C. § 6041 (2000 & Supp. V 2005), the incidence of the costs of information reporting are likely to be passed on to customers in the form of higher prices or to employees in the form of lower wages. By contrast, if information reporting costs were borne by some businesses but not by their competitors, it would be more difficult to shift those costs onto another party by raising prices or lowering wages.

<sup>121</sup> Compliance costs are an important component of the enormous expenses involved in making the income tax function. See SLEMROD & BARIJA, *supra* note 52, at 134–38 (estimating that the total annual cost of enforcing and complying with federal income taxes in 1999 was approximately \$1 billion).

<sup>122</sup> In practice, it is far from obvious that the political process will produce an optimal amount of information. If the incidence of information reporting costs fell on a relatively small but powerful group while creating benefits for the general public, public choice theory would suggest that the political process would tend to produce too little information reporting. See Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 6–7 (1990) (explaining public choice view that narrow, organized interests tend to benefit at the expense of more diffuse interests). Nevertheless, despite whatever flaws the system may exhibit, a mechanism that can constrain authorities' impulses to demand either too much or too little taxpayer information does exist through the electoral process. See *id.*

<sup>123</sup> In this sense, tax information is a public good. As is true of all public goods, ensuring the production of an appropriate amount of tax information requires affirmative government intervention. In theory, private actors could act collectively to acquire information about OID or tax shelters and provide that information to tax authorities. Because everyone derives some measure of benefit from the roads, police protection, national defense, and other services that government provides by way of its tax revenue, everyone has an interest in ensuring that the government is able to collect the taxes it imposes. In reality, coordination problems would make such collective action impossible. Determining how much each person should contribute to the collection effort would be difficult. Ensuring that each beneficiary actually makes a contribution (or, conversely, preventing would-be free-riders from receiving benefits) would be impossible.

they acquire.<sup>124</sup> On the other hand, if the public had an appetite for more information reporting and were willing to bear the resulting costs, tax authorities' access to information would be increased.<sup>125</sup>

One could argue that the success of a government's tax information acquisition efforts is simply a function of how much useful information it produces. After all, if the purpose of collecting information about taxpayers and their activities is to promote compliance, perhaps nothing but its effect on compliance should matter.<sup>126</sup> By this measure, a good system would produce large amounts of information and high levels of compliance and a poor system would not. In practice, ignoring the costs of acquiring tax information would amount to prioritizing tax compliance over other socially valuable government activities and private interests. An additional dollar spent by tax authorities on acquiring tax information could, for example, mean less money available for national defense.<sup>127</sup> On the other hand, if tax authorities could secure the same amount of tax information and compliance at a cost to private parties of either one dollar or five dollars, choosing the cheaper approach could increase social welfare by four dollars.

Within a single jurisdiction, the design of the tax information acquisition infrastructure will at least theoretically be a product of a coherent political process. Because tax authorities ultimately answer to elected officials, there is a political incentive to strike an appropriate balance between ensuring that adequate tax information is collected and curbing the use of ex ante or ex post tools that impose excessive or

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<sup>124</sup> For example, in 1995, the IRS ended the practice of "general audits" of taxpayers pursuant to Taxpayer Compliance Measurement Program ("TCMP") "under pressure from Congress and taxpayer groups among others." Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790, 807 (2007).

<sup>125</sup> Recently, the IRS introduced a successor to the TCMP. *Id.* at 807 n.104. This action could indicate a resurgence of popular support for information acquisition by tax authorities despite its significant cost to taxpayers. Nevertheless, this new program "ha[s] incurred the ire of taxpayers and lawmakers alike." Herman P. Ayayo, *Depth of IRS National Compliance Study Questioned*, 102 TAX NOTES 716, 716 (2004).

<sup>126</sup> In theory, information collected for tax purposes could be used for a host of other government purposes. The circumstances in which taxpayers' information may be used, however, are strictly limited by statute. See I.R.C. § 6103 (West Supp. IV 2008) (as amended by Pub. L. No. 110-172, 121 Stat. 2476 (2007); Pub. L. No. 110-142, 121 Stat. 1803, 1807 (2007)) (generally prohibiting the disclosure of tax "returns and return information" except in specific enumerated situations).

<sup>127</sup> If an additional dollar spent on tax information acquisition would generate \$1.01 in additional tax revenues, this would obviously not be true: the additional information-gathering would pay for itself.

inequitably distributed costs.<sup>128</sup> Likewise, the possibility of voter backlash would prevent authorities from acquiring information taxpayers would prefer to keep out of government hands.<sup>129</sup>

The same is not true, however, in the cross-border context. Without either a robust market<sup>130</sup> or effective supranational government intervention, governments may acquire far too much extraterritorial tax information or far too little. Because such a market does not exist and no government actor has the power to successfully intervene, national governments have been unable to acquire the extraterritorial tax information they need in the global economy to effectively enforce their tax laws.

## II. EXTRATERRITORIAL TAX INFORMATION

Extraterritorial tax information is far more important in 2008 than it was in 1927.<sup>131</sup> Unfortunately, although globalization has transformed the way taxpayers earn their income, there has been no comparable evolution of the tools tax authorities use to gather information.<sup>132</sup> This Part examines the magnitude and implications of the mismatch between private actors' freedom to ignore national borders and the constraints tax authorities face when they attempt to enforce tax laws in a globalized world.<sup>133</sup> The first Section provides two examples of why extraterritorial tax information has become increasingly important to U.S. tax authorities.<sup>134</sup> The next Section considers the unilateral tools

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<sup>128</sup> But see Brown, *supra* note 124, at 807–08 & n.105 (discussing disproportionate audits of low-income taxpayers). A cynic might conclude that the especially vigorous enforcement efforts directed at low-income taxpayers is a product of their lack of political influence.

<sup>129</sup> See Blum, *supra* note 25, at 614–15 (noting congressional compromise allowing the IRS to gather information necessary to enforce the income tax but enacting restrictions on the use of information after its disclosure to the government).

<sup>130</sup> Such a market would provide a mechanism of matching the costs of supplying information with the benefits of receiving it. That market could serve the same purpose among jurisdictions as the internal political process does within a single jurisdiction.

<sup>131</sup> See Steven V. Melnik, *Corporate Expatriations—The Tip of the Iceberg: Restoring the Competitiveness of the United States in the Global Marketplace*, 8 N.Y.U. J. LEGIS. & PUB. POL'Y 81, 92–95 (2004) (noting the current global nature of the economy compared with the far more limited international economy at the time the United States adopted its international tax system).

<sup>132</sup> See Joann M. Weiner, *OECD, IRS Officials Discuss Exchange of Information*, 117 TAX NOTES 135, 135 (2007) (noting tax officials' observations that the "increasing flow of cross-border income and investment is placing increased pressure on countries to improve the exchange of information among tax authorities").

<sup>133</sup> See *infra* notes 138–205 and accompanying text.

<sup>134</sup> See *infra* notes 138–167 and accompanying text.

U.S. tax authorities employ to gather tax information in the cross-border context.<sup>135</sup> Although they are essentially the same as those used effectively within the United States, they have a much more limited extraterritorial reach.<sup>136</sup> The last Section imagines what sort of information might be on U.S. tax authorities' extraterritorial tax information wish lists and explains why no two countries are likely to have lists that are exactly the same.<sup>137</sup>

### A. *The Growing Importance of Extraterritorial Tax Information*

The first phenomenon used to illustrate the importance of extraterritorial tax information for the United States, known as expatriation, involves the tax-motivated abandonment of U.S. citizenship or permanent resident status.<sup>138</sup> The second, tax flight, occurs when U.S. citizens or residents open overseas accounts or form foreign entities to disguise their income in order to hide it from U.S. tax authorities.<sup>139</sup> Both serve as examples of compliance failures that for decades have been the focus of consistent, but unsatisfying, enforcement countermeasures.<sup>140</sup> They also both represent instances in which tax authorities could benefit enormously from access to ex ante extraterritorial tax information on par with the domestic ex ante information they receive with respect to OID and reportable transactions, but instead depend almost entirely on ex post investigative information. In the domestic context, a more balanced approach, involving both ex ante and ex post information, has evolved to address such problems. In the global context, unfortunately, U.S. tax authorities simply have very limited access to useful ex ante extraterritorial tax information.

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<sup>135</sup> See *infra* notes 168–195 and accompanying text.

<sup>136</sup> See *infra* notes 168–195 and accompanying text.

<sup>137</sup> See *infra* notes 196–205 and accompanying text.

<sup>138</sup> See I.R.C. § 877 (2000 & Supp. V 2005); H.R. REP. 108-548, at 253 (2004).

<sup>139</sup> See 1998 OECD REPORT, *supra* note 18, at 21–24; Dean, *supra* note 35, at 924–25.

<sup>140</sup> See, e.g., Treas. Reg. § 1.6011-4(b) (as amended in 2006) (requiring reporting of potential tax shelter transactions); 1998 OECD REPORT, *supra* note 18, at 38–71 (making recommendations to counteract harmful tax competition, including tax havens); ORG. FOR ECON. COOPERATION & DEV., COMM. ON FISCAL AFFAIRS, MODEL CONVENTION FOR MUTUAL ADMINISTRATIVE ASSISTANCE IN THE RECOVERY OF TAX CLAIMS 11 (1981) [hereinafter OECD 1981 MODEL CONVENTION].

## 1. Expatriation

The reach, or perhaps more realistically, the purported reach, of the U.S. income tax is extremely broad.<sup>141</sup> A variety of statutory provisions<sup>142</sup> and bilateral treaties<sup>143</sup> establish limits on the situations in which the United States will attempt to tax the foreign income of U.S. residents and citizens. If none of those special exceptions apply, however, the income earned by any individual born in the United States will be taxed by the United States, even decades after he relocates to a foreign country and even if the income has no actual connection to the United States.<sup>144</sup> For example, a person living in Chile and receiving a dividend from a Russian corporation would be subject to normal U.S. tax on the dividend income.<sup>145</sup>

An entirely different set of rules applies to nonresident noncitizens.<sup>146</sup> For these individuals, only income with a specific connection to the United States is subject to U.S. tax.<sup>147</sup> As a result, dividend income earned by a citizen of the Bahamas would be subject to U.S. tax if the dividend is paid by a U.S. corporation<sup>148</sup> but not if it were paid by a Russian corporation.<sup>149</sup> Because of the sharp divide the United States creates between its citizens and others, the tax advantages of being a Bahamian citizen rather than a U.S. citizen can be substantial.<sup>150</sup>

To limit potential revenue losses attributable to, and also in response to the perceived unfairness of, wealthy individuals escaping the income tax by exchanging their U.S. passports for foreign passports, the United States created a special tax regime targeting the pre-

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<sup>141</sup> See *Cook v. Tait*, 265 U.S. 47, 54–56 (1924) (concluding that income of U.S. citizens, even in the absence of any connection between the income and the United States, is subject to the U.S. income tax); Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 Iowa L. Rev. 863, 870 (2004).

<sup>142</sup> See, e.g., I.R.C. § 911 (West Supp. IV 2008) (amended by Pub. L. No. 110-172, 121 Stat. 2476 (2007)) (allowing U.S. citizens to earn a certain amount and type of income without being subject to U.S. tax); I.R.C. §§ 901, 903–905 (West Supp. IV 2008) (amended by Pub. L. No. 110-172, 121 Stat. 2489–90 (2007)) (allowing tax credit for foreign taxes paid on certain foreign income).

<sup>143</sup> See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 23.

<sup>144</sup> See *Cook*, 265 U.S. at 56.

<sup>145</sup> See I.R.C. § 61 (2000); *Cook*, 265 U.S. at 56.

<sup>146</sup> See Kirsch, *supra* note 141, at 870–73.

<sup>147</sup> See *id.* at 870–71.

<sup>148</sup> See I.R.C. § 861(a)(2) (2000 & Supp. V 2005) (treating dividends paid by U.S. corporations as “income from sources within the United States” subject to U.S. tax).

<sup>149</sup> See I.R.C. § 862(a)(2) (2000) (treating dividends paid by foreign corporations as “income from sources without the United States” not subject to U.S. tax).

<sup>150</sup> See Kirsch, *supra* note 141, at 873.



expatriation gains of those individuals.<sup>151</sup> That regime subjects former U.S. citizens and residents to a kind of alternative minimum tax designed to negate the tax benefits of expatriating.<sup>152</sup> Rather than being subject to the potentially more favorable rules generally available to nonresident aliens, persons subject to those rules will pay the higher of the tax applicable to nonresident aliens and a modified version of the tax paid by U.S. residents.<sup>153</sup>

In theory, because they eliminate key tax benefits of expatriation, these antiexpatriation rules should be quite effective. In recent years, clear rules have increasingly replaced broad standards in an attempt to facilitate improved enforcement.<sup>154</sup> In practice, it is difficult to say whether these measures have much bite. To enforce section 877 of the Internal Revenue Code, tax authorities must have some way of monitoring taxpayers' postexpatriation voluntary compliance.<sup>155</sup> Because expatriation necessarily involves cutting ties to the United States, U.S. tax authorities will have limited ex post information about those postexpatriation activities subject to the alternative tax regime.<sup>156</sup> They will have virtually no access to third-party ex ante information about that income.

## 2. Tax Havens (Tax Flight)

For those individuals unwilling or unable to sever their real-world ties to the United States, the existence of offshore tax havens provides a form of "virtual" expatriation: tax flight. Rather than changing their own tax status, U.S. individuals willing to break the law can create offshore accounts or entities to produce the illusion that their invest-

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<sup>151</sup> See I.R.C. § 877 (2000 & Supp. V 2005) (imposing a broadened "alternative tax" on expatriates); H.R. REP. NO. 108-755, at 581-92 (2004) (Conf. Rep.), as reprinted in 2004 U.S.C.C.A.N. 1341, 1647-58.

<sup>152</sup> See I.R.C. § 877; H.R. REP. NO. 108-755, at 582-92.

<sup>153</sup> See I.R.C. § 877(b).

<sup>154</sup> See H.R. REP. NO. 108-755, at 582-83; Kirsch, *supra* note 141, at 885-87 (describing 1996 statutory amendments intended to replace relatively subjective standards with more "objective" rules). More recent statutory amendments shifted the balance even more strongly in favor of rules by eliminating the requirement that the expatriation be tax motivated. H.R. REP. NO. 108-548, at 253 (2004).

<sup>155</sup> Tax authorities are theoretically required to monitor sales of foreign stock by non-resident alien individuals. See, e.g., I.R.C. § 877(d)(1)(C) (expanding U.S. taxation of income derived by expatriates from sales of stock in certain foreign corporations by treating those gains as a U.S. source).

<sup>156</sup> The Internal Revenue Code does require self-reporting from individual taxpayers subject to the alternative tax. I.R.C. §§ 877(b), 6039G (2000 & Supp. V 2005).

ments, including their U.S. investments, belong to foreign persons.<sup>157</sup> The existence of those accounts or entities has no effect on their owners' legal obligations to pay U.S. income tax.<sup>158</sup> If the illusion is successful, however, and if the associated income is not voluntarily reported, U.S. tax authorities will have no opportunity to pursue a claim for unpaid taxes.<sup>159</sup>

In recent years, tax flight has received a great deal of attention.<sup>160</sup> Both international organizations such as the Organization for Economic Cooperation and Development ("OECD") and individual governments have devoted time and resources to studying the problem.<sup>161</sup> Despite those official efforts and a consensus that the solution to the tax flight problem is greater access to extraterritorial tax information,<sup>162</sup> estimates of annual revenue losses suggest that tax flight (\$50 billion)<sup>163</sup> may still be a bigger problem than false earned income tax credit claims (\$9 billion) and corporate underreporting (\$30 billion, including \$10 billion to \$15 billion in tax shelters) combined.<sup>164</sup> Even tax havens' publicly stated intentions to combat tax flight have been slow to produce much in the way of actual change.<sup>165</sup>

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<sup>157</sup> In the case of one Cayman bank under investigation by the Department of Justice, there was virtually nothing foreign about the bank or its activities. Joseph Guttentag & Reuven Avi-Yonah, *Closing the International Tax Gap*, in BRINGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 99, 99-100 (Max B. Sawicky ed., 2005) ("[B]oth the underlying funds . . . and the investment income, were generally purely [U.S.] domestic transactions . . .").

<sup>158</sup> See Weiner, *supra* note 132, at 135.

<sup>159</sup> See Guttentag & Avi-Yonah, *supra* note 157, at 100.

<sup>160</sup> See, e.g., 1998 OECD REPORT, *supra* note 18, at 7-18 (identifying the existence of tax havens as a major threat to global welfare); Weiner, *supra* note 132, at 135; Bruce Zagaris, *The Procedural Aspects of U.S. Tax Policy Towards Developing Countries: Too Many Sticks and No Carrots?*, 35 GEO. WASH. INT'L L. REV. 331, 332-33 (2003) (describing recent U.S. efforts to reinvestigate its Tax Information Exchange Agreement program).

<sup>161</sup> See, e.g., 1998 OECD REPORT, *supra* note 18, at 7-18, 20-22; Zagaris, *supra* note 160, at 332-33.

<sup>162</sup> See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1667-76 (2000) (proposing the creation of an information reporting/withholding tax regime by developed countries to combat tax flight by increasing access to extraterritorial tax information); Dean, *supra* note 35, at 957-60 (proposing tax flight treaties that provide greater access to extraterritorial tax information); Guttentag & Avi-Yonah, *supra* note 157, at 105-06.

<sup>163</sup> Guttentag & Avi-Yonah, *supra* note 157, at 101.

<sup>164</sup> Sawicky, *supra* note 6, at 4-6.

<sup>165</sup> Maria Flavia Ambrosanio & Maria Serena Caroppo, *Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms*, 53 CAN. TAX J. 685, 710 (2005) (noting that most tax havens that "announced programs of reform . . . have not yet put their formal commitments into practice").

The heart of the problem lies in the vast gulf between the information to which tax authorities have access domestically and the information they are able to collect abroad.<sup>166</sup> That gap is so large that the incremental gains achieved by these anti-tax-flight efforts still leave tax authorities with far less access to ex post and especially to ex ante tax information than they rely on domestically.<sup>167</sup>

### B. *Limits of Unilateral Extraterritorial Tax Information Acquisition*

When U.S. tax authorities face a domestic enforcement problem comparable to international issues like tax flight or expatriation, they may not always succeed in bringing taxpayers to heel, but at the very least they have the capacity to acquire the information they need to attempt enforcement.<sup>168</sup> By contrast, the threshold issue in the campaign to eliminate tax flight is access to information about taxpayers' investments.<sup>169</sup> In a sense, the same is true with respect to expatriations.<sup>170</sup> Although both tax flight and expatriations represent troubling vulnerabilities in the U.S. income tax, each is also a symptom of the broader threat to the integrity of national tax systems posed by the inability of tax authorities to gain access to extraterritorial tax information in an increasingly globalized world.<sup>171</sup> Even when taxpayers do not go to such extraordinary lengths to avoid taxes, the inability of tax authorities to observe and investigate their extraterritorial activities can give taxpayers the upper hand.<sup>172</sup>

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<sup>166</sup> See Tillinghast, *supra* note 8, at 39 (noting that in the international context "a large part of the information the IRS needs is not directly available to it"); *id.* at 51 (noting power of third-party summons but that it is only available when the third party falls under U.S. courts' jurisdiction).

<sup>167</sup> See generally *id.* For example, even if tax havens were to report every dollar of cash interest paid to U.S. citizens, U.S. tax authorities would still be left without access to annual OID information. Under those circumstances, taxpayers could effectively choose whether or not to be subject to current taxation by choosing whether to receive current cash interest payments. An investigation of a particular taxpayer would be the only way for tax authorities to identify and correct resulting compliance failures.

<sup>168</sup> See, e.g., I.R.C. §§ 7601-7613 (West 2002 & Supp. 2007) (authorizing investigative and enforcement powers of the IRS including summons and power to execute search and arrest warrants, among others).

<sup>169</sup> See 1998 OECD REPORT, *supra* note 18, at 7-18 (identifying the existence of tax havens as a major threat to global welfare); Zagaris, *supra* note 160, at 332-33 (describing recent U.S. efforts to reinvigorate its Tax Information Exchange Agreement program).

<sup>170</sup> Without access to information with respect to expatriate taxpayers' foreign investment income, authorities have no way of monitoring compliance with its special alternative tax regime.

<sup>171</sup> See Tillinghast, *supra* note 8, at 39-43, 49-57.

<sup>172</sup> See *id.*

As described below, one aspect of the information gap results from the weakness of U.S. tax authorities' foreign investigative powers.<sup>173</sup> Even more significant, however, is the increasingly stark contrast between the ability of tax authorities to acquire ex ante information domestically and their much more limited ability to collect the same information globally. Because their investigative powers were crafted to work in tandem with, rather than as a substitute for, observation, even when tax authorities are able to achieve some success in their foreign investigations, levels of compliance are likely to remain much lower with respect to extraterritorial income than they are domestically.<sup>174</sup>

### 1. Extraterritorial Ex Ante Information Reporting

Because U.S. tax rules apply to foreign income in much the same way as they apply to income generally, ex ante information reporting is just as important with respect to extraterritorial tax information as it is domestically.<sup>175</sup> For instance, OID income earned by a U.S. citizen or resident is generally subject to U.S. tax, whether it is earned with respect to a debt instrument issued by a corporation headquartered in Ohio or in Japan.<sup>176</sup> In an ideal world, U.S. tax authorities could count on receiving the same information with respect to the Japanese OID as they would for a domestic instrument.

Unfortunately, in practice it is much more difficult to acquire information about the foreign debt instrument. First, although U.S. tax authorities can compel domestic issuers and intermediaries to provide them with whatever information they deem appropriate, their Japanese counterparts will often be out of reach.<sup>177</sup> One explanation for that result lies in the jurisdictional boundaries and conflicts that limit countries' ability to exercise authority outside their borders.<sup>178</sup> A second fac-

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<sup>173</sup> See *id.*

<sup>174</sup> See Lederman, *supra* note 7, at 698.

<sup>175</sup> See *Cook*, 265 U.S. at 54-56 (concluding that income of U.S. citizens, even in the absence of any connection between the income and the United States, is subject to the U.S. income tax).

<sup>176</sup> See *id.*

<sup>177</sup> See I.R.C. § 6049(b)(2)(C)(iii) (West Supp. 2007) (exempting interest paid by foreign corporations not engaged in a U.S. trade or business from the interest reporting requirements unless specified by regulations).

<sup>178</sup> See Tillinghast, *supra* note 8, at 39. Tillinghast notes that although the IRS "considers any foreign person making payments of U.S.-source income to be a statutory withholding agent. It has no practical way to enforce this obligation . . ." *Id.* He also observes that "[i]f the payment is something other than U.S. source income subject to U.S. withholding tax, the IRS has no basis for requiring compliance." *Id.*

tor, unique to the tax context, is the very different question of whether a foreign corporation not doing business in the United States would even have the capacity to provide the specific information sought by U.S. tax authorities. For a foreign corporation to report OID it would be required both to (1) apply reliably the elusive U.S. distinction between debt and equity<sup>179</sup> and (2) master the complex U.S. OID regime.<sup>180</sup>

Because each country's tax regime evolves in response to a range of unique factors,<sup>181</sup> foreign actors unfamiliar with U.S. tax rules may not be in a position to generate the information sought by U.S. tax authorities. For example, if Japan chose not to tax OID, or did so according to a significantly different regime,<sup>182</sup> even if U.S. authorities overcame the jurisdictional impediments to imposing reporting requirements on Japanese borrowers, the amount of "interest" reported by such a borrower as paid to a U.S. lender might be useless to U.S. tax authorities.<sup>183</sup> Of course not every type of income implicates rules as singular as those that govern the debt/equity distinction and OID. Still, even relatively subtle differences between countries' tax systems represent a significant obstacle to acquiring useful *ex ante* extraterritorial tax information.<sup>184</sup>

Even at the most basic level, those incompatibilities can pose real problems for tax authorities. The best example of this is the mechanism tax authorities use to match information reported by third parties with a particular taxpayer.<sup>185</sup> Domestically, tax authorities are able to rely on TINs to accomplish the task.<sup>186</sup> In the cross-border context, because TINs vary from jurisdiction to jurisdiction,<sup>187</sup> even when extrater-

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<sup>179</sup> See generally William T. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971) (providing the classic analysis of the tax law's debt/equity distinction).

<sup>180</sup> See *supra* notes 64–72 and accompanying text (discussing OID regime in the United States).

<sup>181</sup> See Ring, *supra* note 65, at 88–89.

<sup>182</sup> See *id.* at 90–92 (noting differences in U.S. and Japanese treatment of OID).

<sup>183</sup> See Tillinghast, *supra* note 8, at 47 (describing significance of inconsistencies between characterization of income under the U.S. and other systems).

<sup>184</sup> An example of such subtle differences are those that give rise to the problem of international tax arbitrage. See Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89, 91 (2004) (describing tax arbitrage generally as a "situation[] in which a taxpayer achieves some tax benefit in virtue of an inconsistency between the laws of two or more jurisdictions").

<sup>185</sup> See Avi-Yonah, *supra* note 162, at 1584 ("[T]he lack of any uniform, worldwide system of tax identification numbers means that most tax administrations are unable to match the information they receive from their treaty partners with particular domestic taxpayers.").

<sup>186</sup> See, e.g., I.R.C. §§ 6039G, 6050I, 6050L, 6050P (2000 & Supp. V 3005) (requiring disclosure of TINs as a component of reporting particular transactions).

<sup>187</sup> See Avi-Yonah, *supra* note 162, at 1584.

ritorial tax information consistent with U.S. tax principles is available, it may not be very useful.<sup>188</sup> Unless a party reporting ordinary cash interest paid to a U.S. taxpayer were also persuaded to collect a U.S. taxpayer identification number and provide it along with the interest information, U.S. tax authorities may be unable to derive much benefit from the information.<sup>189</sup>

## 2. Extraterritorial Ex Post Information Acquisition

Most of the obstacles to acquiring ex ante extraterritorial tax information do not affect U.S. tax authorities' investigative power.<sup>190</sup> The lack of TINs, for example, is more of a nuisance than a significant impediment if authorities are focused on the activities and income of a single taxpayer. Jurisdiction, however, is every bit as problematic for U.S. tax authorities when they attempt to conduct investigations as it is in the context of observation.<sup>191</sup> Because they lack the power to compel foreign third parties to provide extraterritorial tax information, U.S. investigators generally have little access to third-party information that could confirm or counter the information taxpayers voluntarily report about their own activities.<sup>192</sup> As a result, tax authorities have no choice but to seek assistance from the very taxpayers under investigation.

Unsurprisingly, taxpayers tend to see little benefit in cooperating with investigators.<sup>193</sup> To give U.S. authorities greater leverage, Congress

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<sup>188</sup> Letter from Mark W. Everson, Dep't of the Treasury, to the Honorable Max Baucus, Ranking Member, U.S. Senate Comm. on Fin. 2 (June 12, 2006) [hereinafter *Everson Letter*], reprinted in *Everson Explains U.S. I.R.S.'s Use of Foreign-Source Income Data*, *WORLDWIDE TAX DAILY*, June 16, 2006 (citing lack of TINs as one of the key problems to making effective use of existing information exchange agreements).

<sup>189</sup> See *id.*

<sup>190</sup> By the same token, during the course of a given investigation, U.S. authorities should have little difficulty adapting extraterritorial tax information to conform to U.S. tax principles.

<sup>191</sup> In one recent instance, authorities solved the problem posed by their lack of jurisdiction over foreign banks by issuing a "John Doe" summons for the credit card records of U.S. retailers, including Lenscrafters and CompuServe, to "reveal the identities of persons known to have paid for transactions with these merchants using a MasterCard payment card issued by a bank in Antigua and Barbuda, the Bahamas, or the Cayman Islands." *In re Tax Liabilities of John Does*, 91 A.F.T.R.2d (RIA) 2003-433, ¶ 2003-327 (S.D. Ohio 2002) (granting motion to issue third-party John Doe summonses). In this case, investigators were able to identify domestic actors with access to the information they needed and were thus able to compel its production. See *id.* Generally, they will not have that luxury.

<sup>192</sup> See Tillinghast, *supra* note 8, at 39.

<sup>193</sup> That lack of cooperation can hobble an investigation. See Edmund L. Andrews, *I.R.S. Curtails Many Audits in Tax Havens*, *N.Y. TIMES*, May 3, 2007, at C1 ("In one case . . . the I.R.S. spent four years investigating a person with businesses in both the United States

created a statute that prevents taxpayers from failing to supply information during an investigation only to later introduce that "foreign-based documentation" at trial.<sup>194</sup> Unfortunately, it appears these efforts have not been successful in leveling the playing field. The current environment often leaves investigators unable to successfully complete (and sometimes unwilling to initiate) audits of taxpayers suspected of offshore tax evasion.<sup>195</sup>

### C. Different Needs for Different Countries

As is evident, governments face an array of obstacles to their acquisition of extraterritorial tax information.<sup>196</sup> At the same time, their need for that information is broad and continues to grow.<sup>197</sup> But countries not only need a great deal of extraterritorial tax information. They are also likely to have different needs for such information. Several examples illustrate this point.

As previously discussed, individuals who are U.S. citizens and residents are subject to U.S. income tax on their worldwide income.<sup>198</sup> In

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and an unnamed overseas tax haven. The investigation included 20 summonses, 23 demands for documents, 5 missed appointments and 2 refusals by the person being investigated to supply information. After four years, the government still did not know how much money had been moved to the tax haven.").

<sup>194</sup> I.R.C. § 982 (2000). The statute provides that in any case in which authorities present a taxpayer with a "formal document request" and the taxpayer proves unwilling or unable to provide the information during the course of their examination "any court having jurisdiction of a civil proceeding . . . shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such request." I.R.C. § 982(a). A "formal document request" covered by the provision must be "mailed by registered or certified mail to the taxpayer at his last known address" and specify when and where the information must be provided, along with a description of the required information and the consequences of a failure to produce it. I.R.C. § 982(c)(1). A taxpayer may avoid application of the statute when the failure to produce the information is due to "reasonable cause." I.R.C. § 982(b)(1). However, the fact that "a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause." I.R.C. § 982(b)(2).

<sup>195</sup> Andrews, *supra* note 193 ("The Internal Revenue Service is curtailing audits of many people who use offshore tax havens, even when agents see signs of tax evasion, because agents fear they cannot meet a three-year deadline for finishing an examination . . .").

<sup>196</sup> See *supra* notes 141-195 and accompanying text.

<sup>197</sup> See Vito Tanzi, *Is There a Need for a World Tax Organization?*, in *THE ECONOMICS OF GLOBALIZATION: POLICY PERSPECTIVES FROM PUBLIC ECONOMICS* 173, 173-86 (Assaf Razin & Efraim Sadka eds., 1999) (noting "policy-makers are lagging behind the recent technological developments in the financial markets").

<sup>198</sup> See *Cook*, 265 U.S. at 54-56 (concluding that income of U.S. citizens, even in the absence of any connection between the income and the United States, is subject to the U.S. income tax); Kirsch, *supra* note 141, at 870.

addition to being subject to U.S. tax on income they earn directly, U.S. taxpayers are sometimes taxed on income earned by foreign entities.<sup>199</sup> For example, shareholders of foreign corporations that earn large amounts of "passive" income<sup>200</sup>—Passive Foreign Investment Companies ("PFICs")—can elect to be taxed currently on income earned by the foreign corporation under the Qualified Electing Fund ("QEF") regime.<sup>201</sup> The intent of these provisions is to "remove the economic benefit attributable to tax deferral" for PFIC investors.<sup>202</sup> But because U.S. tax authorities have only limited access to PFIC information from overseas, rates of voluntary compliance with respect to foreign income are likely to be relatively low when compared to similar domestic income. Likewise, U.S. corporations face different risks and rewards with respect to underreporting their foreign income than with respect to income earned domestically. The variety of information tax authorities need to ensure compliance with these foreign income regimes illustrates the need for wide-ranging types of extraterritorial tax information. For example, the *ex ante* extraterritorial tax information that U.S. tax authorities might use, generally, to monitor U.S. taxpayers' compliance with the complex QEF regime<sup>203</sup> bears virtually no resemblance to the *ex post* information that would be useful during the course of an investigation of a single taxpayer suspected of underreporting the amount of interest earned in a hidden offshore bank account. As with

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<sup>199</sup> See, e.g., I.R.C. § 951 (West Supp. IV 2008) (amended by Pub. L. No. 110-72, 121 Stat. 2476 (2007)) (requiring "U.S. shareholders" of "controlled foreign corporations" to include certain categories of undistributed corporate income currently); I.R.C. §§ 1293, 1296 (2000 & Supp. V 2005) (taxing shareholders of certain "passive foreign investment companies" on income earned by those corporations before the income is distributed to the shareholders).

<sup>200</sup> I.R.C. §§ 954(c), 1297(b) (amended by Pub. L. No. 110-172, 121 Stat. 2475(2007)) (defining passive income as dividends, interest, and similar items).

<sup>201</sup> I.R.C. § 1295 (2000) (allowing shareholders in PFIC to elect QEF treatment). As is true of the OID rules discussed above, the mechanics of the QEF rules and of similar anti-deferral regimes are much more complicated than the policy objective they serve. A PFIC is a foreign corporation that earns a high percentage of "passive" income or holds a high percentage of passive assets. See I.R.C. § 1297(a). A PFIC shareholder can elect to treat any PFIC as a QEF by filing an election. See I.R.C. § 1295.

<sup>202</sup> BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS* ¶ 15.44[3] (Thomson 7th ed. 2006).

<sup>203</sup> To satisfy the QEF requirements, shareholders must report detailed information about the earnings of the foreign corporation in which they hold a stake. Given the limitations of their capacity to acquire extraterritorial tax information, U.S. tax authorities have little opportunity to verify the information voluntarily reported by taxpayers through either observation or investigation. With greater access to *ex ante* or *ex post* information, authorities could encourage greater voluntary compliance and would be better positioned to identify and correct compliance failures.



the information tax authorities use to monitor compliance with the OID rules, the ex ante information for QEF monitoring purposes would require more than a record of payments made or received. Instead, for tax authorities to accurately determine the tax consequences of owning shares in a QEF, they require detailed information about the nature of the foreign entity's activities and assets.<sup>204</sup> With these two very different sorts of information in mind (i.e. ex post interest information and ex ante QEF information), it is not difficult to imagine that jurisdictions confronting different enforcement issues based on unique regimes might have very different appetites for extraterritorial tax information.

At the most basic level, those differences are likely to be a function of the sophistication of the tax system in question. A tax system that incorporates concepts such as OID and QEFs is likely to demand more information, both in terms of quantity and quality, than a country that has only a rudimentary income tax or no income tax at all. Similarly, a jurisdiction that relies heavily on observation and ex ante information reporting will need far more information than a country that favors ex post methods. Those disparities are likely to be correlated with differences in size and national wealth, because countries with the greatest need for tax information are likely to be relatively large, wealthy countries with sophisticated economies and ample administrative resources like the United States. To the extent those relatively wealthy countries tend to be capital exporters<sup>205</sup> rather than capital importers, the differences in their relative needs will be exacerbated. As a result, there are almost certain to be major systematic differences in both the types and volumes of extraterritorial tax information needed by different countries.

A simple, if somewhat stylized, example may help to frame the discussion of the existing extraterritorial tax information acquisition regime and to explain the need for change. Imagine a large, wealthy country and a significantly smaller and less economically developed neighbor. In part because of their proximity, a considerable amount of cross-border activity links the two countries. The first country employs an income tax that employs sophisticated concepts comparable to OID,

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<sup>204</sup> For example, the amount and character of QEF income imputed to a taxpayer in any given year can depend on the PFIC's percentage ownership of its subsidiaries. See, e.g., I.R.C. § 1298(a)(2), (b)(8) (distinguishing between corporations based on percentage ownership).

<sup>205</sup> Tsilly Dagan, *The Tax Treaties Myth*, 32 N.Y.U. J. INT'L L. & POL. 939, 989 (2000) (observing that developing countries are disproportionately likely to be capital importers).

while the second imposes only a sales tax that applies to goods purchased abroad and used domestically.

Both countries would benefit significantly from receiving extraterritorial tax information on par with the information they receive from domestic sources. For the smaller country, that information might consist of a limited amount of *ex post* data regarding purchases made abroad by its residents. The larger country is likely to have the capacity to process a high volume of *ex ante* extraterritorial tax information. As a result, although the two governments share an appetite for extraterritorial tax information, the type, amount, and timing of information each would like to receive are dramatically different. Creating a system that produces a healthy flow of information and ensures that both countries shoulder burdens commensurate with the benefits they expect to derive poses considerable challenges.

### III. THE INCOMPLETE MARKET FOR EXTRATERRITORIAL TAX INFORMATION

Although extraterritorial tax information has become far more elusive and important since the early days of the income tax, the primary tool used to acquire it has, if anything, become less potent. At the same time, even though jurisdictions have developed very different appetites for extraterritorial tax information, the eighty-year-old barter mechanism used to facilitate the cross-border flow of tax information continues to presuppose a level of cross-border symmetry that may never have really existed. Part IV asks whether a more complete market, in which countries are free to use cash consideration and to regularly acquire extraterritorial tax information other than simple lists of raw data, might help to close the growing gap between the amount of information jurisdictions would like to have and the amount they currently receive.<sup>206</sup> This Part sets the stage for that discussion by tracing the history of the extraterritorial tax information barter system.<sup>207</sup>

Just as the architects of the international system originally envisioned, countries rely on reciprocal information exchange provisions of international agreements to ensure access to information that would otherwise lie out of their reach.<sup>208</sup> Surprisingly, even as the need for extraterritorial tax information has expanded, the rights countries ac-

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<sup>206</sup> See *infra* notes 337–411 and accompanying text.

<sup>207</sup> See *infra* notes 208–336 and accompanying text.

<sup>208</sup> See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

quire under those agreements have become weaker.<sup>209</sup> In some respects, the changes are so stark that modern information exchange provisions are actually designed to prevent the exchange of information that once flowed automatically.<sup>210</sup> As a result, in contrast to their ample capacity to procure tax information domestically, governments have access to a relatively limited amount of extraterritorial tax information.

This Part begins by describing the League of Nation's (the "League") 1927 Draft of a Bilateral Convention on Administrative Assistance in Matters of Taxation, which represented the first attempt to create a global solution to the problem of acquiring extraterritorial tax information.<sup>211</sup> That model agreement essentially proposed that each country buy access from other countries to extraterritorial tax information, including *ex ante* information, with a pledge to provide them with comparable information.<sup>212</sup> This Part then explains how the principles of that model information exchange agreement were reduced to practice and explores subsequent developments in the market for extraterritorial tax information.<sup>213</sup> Finally, it considers the extent to which information exchange has succeeded in providing U.S. tax authorities with the information necessary to enforce the income tax.<sup>214</sup> It con-

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<sup>209</sup> See *infra* notes 245–317 and accompanying text.

<sup>210</sup> See *infra* note 283 and accompanying text (noting that today's information exchange provisions fall far short of those in the 1939 treaty between the United States and Sweden). Compare U.S. 2006 Model Convention, *supra* note 16, art. 26, U.N. 2001 Model Convention, *supra* note 16, art. 26, and OECD 2005 Model Convention, *supra* note 16, art. 26, with Convention Respecting Double Taxation, U.S.-Swed., Mar. 23, 1939, 54 Stat. 1759 [hereinafter U.S.-Sweden 1939 Treaty].

<sup>211</sup> See *infra* notes 216–244 and accompanying text.

<sup>212</sup> See 1927 Report, *supra* note 21, at 22–23. Tax authorities have a choice as to how they acquire tax information. They can either compel its production or bargain for it. Most countries, including the United States, do both. As described above, they rely more on compulsion than bargaining domestically. By necessity, they bargain for extraterritorial tax information. One obvious explanation for favoring compulsion over bargaining domestically is that it obviates the need for tax authorities to communicate individually with domestic employers and financial institutions to gain access to information about taxpayers. Instead, the government simply requires those private actors to supply that information, typically without providing compensation. Within its own borders, there is simply no reason for a tax authority to bargain for information. In gathering extraterritorial tax information, however, a tax authority frequently finds itself in a very different position. Since the 1920s, countries have recognized the need to bargain with one another to acquire extraterritorial tax information.

<sup>213</sup> See *infra* notes 245–317 and accompanying text.

<sup>214</sup> See *infra* notes 318–336 and accompanying text.

cludes that the current barter regime has fallen far short of that goal and explores the reasons for its failure.<sup>215</sup>

### A. The 1927 Report

Tax authorities routinely receive extraterritorial tax information from foreign governments.<sup>216</sup> Often, as described in the next Section, that information is provided pursuant to the tax information exchange provisions of a broad bilateral tax treaty or pursuant to a free-standing tax information exchange agreement.<sup>217</sup> The origins of those obligations can be traced back to the work of the League of Nations in the post-World War I era.<sup>218</sup>

It would be difficult to overstate the significance of the work of the committees and experts that culminated in the production of the 1928 model double taxation treaty<sup>219</sup> that formed the basis for the bilateral double tax treaties that are the foundation of today's very successful international tax regime.<sup>220</sup> Despite relatively minor differences of opinion as to exactly how much credit those experts deserve,<sup>221</sup> there is

<sup>215</sup> See *infra* notes 318–336 and accompanying text.

<sup>216</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26 (providing for information exchange within bilateral double taxation treaties); OECD 2005 Model Convention, *supra* note 16, art. 26; Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOK. J. INT'L L. 1357, 1358 (2001) (estimating the existence of more than 1700 bilateral double tax treaties); Zagaris, *supra* note 160, at 349 (discussing often voluminous information received).

<sup>217</sup> See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26. (providing for information exchange within bilateral double taxation treaties); OECD 2005 Model Convention, *supra* note 16, art. 26; Zagaris, *supra* note 160, at 332–57 (discussing recent proliferation of stand-alone tax information exchange agreements ("TIEAs")).

<sup>218</sup> See generally Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.562.M.178 II 1928 (1928) [hereinafter 1928 Government Experts Report]; 1927 Report, *supra* note 16.

<sup>219</sup> See 1928 Government Experts Report, *supra* note 218, at 7–21.

<sup>220</sup> See Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1306 (1996) (noting that the principles of a 1923 League of Nations report underlie the current consensus regarding the structure of international taxation). Avi-Yonah refers to the current international tax regime as a "miracle," albeit a "flawed" one. See *id.* at 1303–04. According to Avi-Yonah, the fact that "a coherent international tax regime exists that enjoys nearly universal support" and that is "based on voluntary consensus" makes it "one of the major achievements of twentieth-century international law." See *id.*

<sup>221</sup> Compare *id.* at 1306 (noting continued influence of principles embodied in 1923 League of Nations report), with Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1066 n.181 (1997) (noting that the

broad consensus that but for their efforts, today's international tax landscape would look quite different. The year before that model treaty was published, the League's Committee of Technical Experts on Double Taxation and Tax Evasion presented its "general and final report."<sup>222</sup> That report presented four separate model tax conventions.<sup>223</sup> One of those models, the Draft Convention on Administrative Assistance in Matters of Taxation, specifically addressed the acquisition of extraterritorial tax information.<sup>224</sup>

That model, like the other three, was structured as a bilateral agreement between an unnamed pair of countries.<sup>225</sup> The draft specified that each government would be obligated to provide the other with extraterritorial tax information both (i) "following a request concerning concrete cases"<sup>226</sup> and (ii) automatically for enumerated categories of information.<sup>227</sup> Those two distinct requirements parallel the *ex post* and *ex ante* methods of acquiring domestic tax information discussed above.<sup>228</sup> The first, a requirement that each country provide information to the other when served with a specific request for information, permits a country to supplement its domestic investigative capacity.<sup>229</sup> As in the domestic context, that investigative power is paired with a right to receive a steady stream of *ex ante* information.<sup>230</sup> Those rights to *ex ante* information facilitate observation while the *ex post* rights provide assurance that additional extraterritorial tax information can be obtained when necessary.<sup>231</sup>

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historical "role of the International Chamber [of Commerce]" in the development of the tax treaty movement "has been neglected somewhat in recent scholarship").

<sup>222</sup> 1927 Report, *supra* note 16, at 5.

<sup>223</sup> The four drafts were the Bilateral Convention for the Prevention of Double Taxation, the Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties, the Bilateral Convention on Administrative Assistance in Matters of Taxation, and the Bilateral Convention on Judicial Assistance in the Collection of Taxes. *Id.* at 10-30.

<sup>224</sup> *Id.* at 22-23.

<sup>225</sup> *Id.* at 10-30. The choice of a bilateral treaty over a multilateral, or "collective" in the report's terminology, form was driven primarily by the goal of eliminating double taxation. *Id.* at 8 ("In the matter of double taxation in particular, the fiscal systems of the various countries are so fundamentally different that it seems practically impossible to draft a collective convention . . .").

<sup>226</sup> *Id.* at 22.

<sup>227</sup> 1927 Report, *supra* note 16, at 22.

<sup>228</sup> *See id.*

<sup>229</sup> *See id.*

<sup>230</sup> *See id.*

<sup>231</sup> *See id.*

The draft specified the information regarding "natural or juristic persons taxable in one of the two contracting countries" that was to be supplied automatically.<sup>232</sup> That information was to "include the names . . . and . . . residence[s] of the persons concerned, and their family responsibilities, if any . . . ." <sup>233</sup> In addition to that background information, the draft listed six categories with respect to which extraterritorial tax information was to be provided: (1) immovable property; (2) mortgages; (3) industrial, agricultural, and commercial undertakings; (4) earned income and directors fees; (5) transferable securities; and (6) estates.<sup>234</sup> With respect to the fifth item, transferable securities, the model language stated that "any information collected by an administration" <sup>235</sup> should be provided but added "more especially in connection with exemption or relief granted by that authority by reason of the taxpayer's domicile or nationality." <sup>236</sup>

The remainder of the treaty established procedures to allow the participating states to carry out its terms.<sup>237</sup> Each country was expressly granted the right to refuse to provide information when supplying that information would be "contrary to public policy." <sup>238</sup> The treaty established channels of communication between relevant administrative authorities to give effect to the provisions and create measures to implement the convention.<sup>239</sup> Finally, the draft made clear that information would be the only permissible consideration by explicitly requiring that "administrative assistance . . . be given without payment . . . ." <sup>240</sup>

The 1927 model is remarkable for a number of reasons. On the one hand, it clearly demonstrates that the significance of extraterritorial tax information was apparent even in the early days of the income tax.<sup>241</sup> On the other hand, to anyone familiar with today's information

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<sup>232</sup> 1927 Report, *supra* note 16, at 22.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

<sup>235</sup> *Id.* The official commentary explained that "a country which, in the normal course of its fiscal administration, obtains possession of [such information] . . . should impart, on a reciprocal basis, that information to a foreign State which is interested in the matter from the point of view of the equitable distribution of taxation." *Id.* at 24.

<sup>236</sup> *Id.* at 22. When a taxpayer discloses its residence in the foreign jurisdiction as a condition of achieving preferred tax status, the drafters saw a clear duty to report that information to the foreign jurisdiction. *Id.* at 24.

<sup>237</sup> 1927 Report, *supra* note 16, at 22-23.

<sup>238</sup> *Id.* at 23.

<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

<sup>241</sup> *See id.*

exchange provisions, it reveals how subsequent efforts to facilitate the acquisition of extraterritorial tax information have become.<sup>242</sup>

Despite the enormous growth of both the role and the sophistication of the income tax since the 1920s, the League's Draft of a Bilateral Convention on Administrative Assistance in Matters of Taxation represents a high-water mark in extraterritorial tax information acquisition rights. As described below, relatively few international agreements focus specifically on administrative assistance in tax matters.<sup>243</sup> More importantly, current bilateral and multilateral agreements that provide for the acquisition of extraterritorial tax information simply do not call for the same degree of information sharing required by the 1927 model.<sup>244</sup> As a result, although they provide tax authorities with the capacity to investigate taxpayers' extraterritorial activities, they do not give tax authorities the power to observe. The following Section provides an overview of the road that leads from the relatively ambitious 1927 draft to the more modest extraterritorial tax information provisions of the state-of-the-art 2006 U.S. model tax treaty.

### B. *The Decline of Information Exchange*

The four model conventions introduced by the League of Nations in 1927<sup>245</sup> enjoyed very different levels of success. The model designed to prevent the double taxation of income stands head and shoulders above the others.<sup>246</sup> The concepts it introduced have become so impor-

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<sup>242</sup> See *infra* notes 245–317 and accompanying text (describing decline of information exchange in later treaties).

<sup>243</sup> See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26. (providing for information exchange within bilateral double taxation treaties); OECD 2005 Model Convention, *supra* note 16, art. 26; Graetz, *supra* note 216, at 1358.

<sup>244</sup> See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26. Another way to view the difference between the old and new provisions is to see the older language as relatively "hard" law and the newer language as relatively "soft." See Claire R. Kelly, *Realist Theory and Real Constraints*, 44 VA. J. INT'L L. 545, 575–77 (2004) (explaining hard/soft distinction). In other words, although they embrace information exchange in principle, unlike the 1927 model, today's treaties do not create clear entitlements to specific items of information. See, e.g., U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>245</sup> The treaties were published again in 1928, with some variations. See 1928 *Government Experts Report*, *supra* note 218, at 7–33.

<sup>246</sup> See John F. Avery Jones, *The David R. Tillinghast Lecture: Are Tax Treaties Necessary?*, 53 TAX L. REV. 1, 1 (1999) (describing double tax treaties as a "very considerable success story for the OECD and its predecessors, the League of Nations, and the OEEC").

tant that today three principal models, each with roots in the 1927 model, vie for influence over the design of double tax treaties.<sup>247</sup> An enormous number of bilateral treaties bearing the hallmarks of the 1927 model double tax treaty are currently in force.<sup>248</sup> The same cannot be said of the 1927 model administrative assistance convention. While double tax treaties grew ever more popular and evolved to remain effective, despite the increasing sophistication of taxpayers and of domestic tax systems,<sup>249</sup> and to withstand the pressures of globalization,<sup>250</sup> information exchange shriveled.<sup>251</sup> Unlike the 1927 draft, most modern information exchange provisions are little more than a statement of general principles.<sup>252</sup> As a result, countries simply do not have adequate access to extraterritorial tax information.

## 1. London and Mexico Drafts

In the 1940s, the League of Nations followed on its earlier work by issuing two sets of model tax treaties just a few years apart.<sup>253</sup> In 1943, the League published the so-called Mexico drafts and shortly thereafter published the 1946 London drafts.<sup>254</sup> Both the Mexico and the London drafts included both a model double tax treaty and a model treaty focused on administrative assistance.<sup>255</sup>

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<sup>247</sup> See generally 2006 U.S. Model Convention, *supra* note 16; U.N. 2001 Model Convention, *supra* note 16; OECD 2005 Model Convention, *supra* note 16.

<sup>248</sup> Graetz, *supra* note 216, at 1358.

<sup>249</sup> See, e.g., 2006 U.S. Model Convention, *supra* note 16, art. 11(2)(b) (specifying treatment of contingent debt instruments).

<sup>250</sup> See, e.g., *id.* art. 22 (imposing limitations on benefits of forming shell corporations in treaty jurisdictions); see also UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, at 63 (2006) [hereinafter U.S. 2006 MODEL TREATY TECHNICAL EXPLANATION], available at <http://www.ustreas.gov/press/releases/reports/hp16802.pdf> (noting that Article 22 of the treaty is intended to prevent taxpayers from engaging in "treaty shopping").

<sup>251</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention art. 26, *supra* note 16, art. 26.

<sup>252</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention art. 26, *supra* note 16, art. 26.

<sup>253</sup> See Fiscal Comm., *London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations Doc. No. C.88.M.88.1946.II.A., at 6 (1946) [hereinafter *London & Mexico Conventions*].

<sup>254</sup> *Id.*

<sup>255</sup> *Id.* at 58–85 (Model Bilateral Conventions for the Prevention of the Double Taxation of Income and Property); *id.* at 100–17 (Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes; Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Taxes on Income, Property, Estates and Successions).



Each was, in many respects, similar to the drafts published more than a decade earlier. Like the prior draft, both the 1943 and 1946 administrative assistance drafts spelled out in detail the items of information each state was obliged to provide.<sup>256</sup> There were also, however, significant changes from the 1927 version.<sup>257</sup> Rather than creating two distinct drafts to deal with administrative assistance and judicial enforcement, the Mexico and London drafts combined them into a single treaty.<sup>258</sup>

The pair of drafts highlights the fundamental tension created by the barter exchange model, particularly with respect to the automatic exchange of information requirement. Although the later London draft required "readily available information" to be provided automatically, the earlier Mexico draft merely made the supply of that information nondiscretionary.<sup>259</sup> As explained by the official commentary, the requirement that information be supplied automatically was initially thought to "work satisfactorily only in the case of countries having a very well-established tax system and administration."<sup>260</sup> Despite their concerns that a one-size-fits-all approach would not always work, by the time of the London draft, the League decided to include the automatic exchange requirement.

## 2. Bilateral Double Tax Treaties

Even before the League created the Mexico and London drafts of its administrative assistance treaty, the concept of a stand-alone administrative assistance treaty had begun to give way.<sup>261</sup> As illustrated by some of the earliest U.S. double tax treaties, instead of creating one treaty for fighting double taxation and another to combat fiscal eva-

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<sup>256</sup> See *id.* at 102-03 (requiring that each state provide the name and address of any person deriving income from that state and having an address in the other and to provide all information obtained from financial institutions relating to persons with an address in the other state). Both the London and Mexico drafts contain this requirement. *Id.*

<sup>257</sup> Compare *id.* at 100-17, with 1927 Report, *supra* note 16, at 22-30.

<sup>258</sup> Compare London & Mexico Conventions, *supra* note 253, at 100-17, with 1927 Report, *supra* note 16, at 22-30. The commentary explained that the two treaties were combined in part because "the kind of co-operation which is required for reciprocal assistance between administrations for the assessment and for the collection of taxes is substantially the same in both fields." London & Mexico Conventions, *supra* note 253, at 44.

<sup>259</sup> See London & Mexico Conventions, *supra* note 253, at 51.

<sup>260</sup> See *id.*

<sup>261</sup> See, e.g., U.S.-Sweden 1939 Treaty, *supra* note 210, art. XVI (incorporating information exchange); Income Tax Convention Respecting Double Taxation art. 21, U.S.-Fr., July 25, 1939, 59 Stat. 893 [hereinafter U.S.-France 1939 Treaty] (incorporating information exchange).

sion, a single treaty was designed to serve both purposes.<sup>262</sup> Ultimately, that combination proved a mixed blessing for extraterritorial tax information acquisition.

In one sense, abandoning the separate administrative assistance treaty in favor of a hybrid treaty served to further the goal of facilitating extraterritorial tax information acquisition. Given the ubiquity of double tax treaties, it seems likely that the pairing may have created information exchange relationships that would not have existed otherwise.<sup>263</sup> At the same time, by relegating information exchange to a supporting role, the combination both diluted and limited the impact of the information exchange requirement. As the significance of the treaties' double tax provisions came to predominate, the information exchange provisions became more modest.<sup>264</sup> In addition, gaps in the

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<sup>262</sup> See, e.g., U.S.-Sweden 1939 Treaty, *supra* note 210, art. XVI; U.S.-France 1939 Treaty, *supra* note 261, art. 21.

<sup>263</sup> For example, less than a year after a U.S. effort to create a "system for international exchange of tax data through which the participating countries will be able to locate funds which their nationals have invested or have on balance abroad," faltered, see E.S. Duffield, *System Proposed for International Tax Data Exchange*, WALL ST. J., June 22, 1937, at 1, the United States "began discussions [with Sweden] looking toward a treaty between the two countries on interchange of tax information." See *U.S. and Sweden Treaty Talks*, WALL ST. J., Sept. 13, 1938, at 9. Although the United States had intended to advance information exchange through the League of Nations in 1937, the League rejected it. See *To Join Geneva Tax Talk*, N.Y. TIMES, Sept. 28, 1937, at 17 (noting U.S. intent to advance its information exchange plan at a meeting of the League of Nations); *League Dodges Tax Plan*, N.Y. TIMES, Oct. 20 1937, at 19 (noting the League's rejection of the plan because of objections to requiring their citizens to supply information needed only by a foreign state). The U.S.-Sweden treaty ultimately contained both information exchange provisions and elements designed to mitigate double taxation. See generally U.S.-Sweden 1939 Treaty, *supra* note 210. By comparison, the very first treaty with Canada contained no provisions on information exchange. Convention Concerning Income Taxation, U.S.-Can., Dec. 30, 1936, 50 Stat. 1399. Information exchange with Canada was originally implemented by regulation. See *U.S. and Canada to Swap Tax Data on Their Citizens*, CHRISTIAN SCI. MONITOR, Oct. 6, 1937, at 10.

<sup>264</sup> One of the earliest U.S. tax treaties contained information exchange provisions at least as potent as those in the League of Nations models. Article XVI of the 1939 U.S.-Sweden Treaty required the following of the United States:

1. In accordance with the preceding Article, the competent authorities of the United States of America shall forward to the competent authorities of Sweden as soon as practicable after the close of each calendar year the following information relating to such calendar year:

(a) The names and addresses of all addressees within Sweden deriving from sources within the United States of America dividends, interest, royalties, pensions, annuities, or other fixed or determinable annual or periodical income, showing the amount of such income with respect to each addressee;

(b) Any particulars which the competent United States authorities may obtain from banks, savings banks or other similar institutions concerning assets

international network of double tax treaties became an important obstacle to the flow of extraterritorial tax information between jurisdictions that did not share a double tax treaty.<sup>265</sup>

To understand how radically the terms of a typical information exchange provision have changed over the years, it is helpful to compare several pre-1950 treaties with a modern information exchange provision. The model tax treaty published by the United States in 2006 includes a typical modern "Exchange of Information" article.<sup>266</sup> That article states that the tax authorities of the two parties "shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes . . . ."<sup>267</sup> The requirement that each state provide information sought by the other clearly offers a powerful extraterritorial tax information acquisition tool.<sup>268</sup> Nevertheless, by contrast with the 1927 model or even the early U.S.-Sweden tax treaty,<sup>269</sup> the rights granted by the 2006 U.S. model information exchange provisions are relatively modest. They contain no specific requirements for information disclosure, much less automatic disclosures of particular information.<sup>270</sup>

The 2006 U.S. model, like most modern treaties, takes the approach of the Mexico draft by making information exchange mandatory, but not automatic.<sup>271</sup> On the one hand, so long as the information bears the necessary relationship to taxation, and providing the information would not "be contrary to public policy," each treaty partner is

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belonging to individuals resident in Sweden or to Swedish corporations or other entities.

U.S.-Sweden 1939 Treaty, *supra* note 210, art. XVI. As explained below, the rights provided by today's information exchange provisions fall far short of those granted by that early U.S.-Sweden treaty. See *infra* notes 271-283 and accompanying text.

<sup>265</sup> See Zagaris, *supra* note 160, at 332-34 (describing recent efforts to fill those gaps with TIEAs).

<sup>266</sup> U.S. 2006 Model Convention, *supra* note 16, art. 26.

<sup>267</sup> *Id.* art. 26(1).

<sup>268</sup> See *id.*

<sup>269</sup> Compare *id.*, with U.S.-Sweden 1939 Treaty, *supra* note 210, art. XVI and 1927 Report, *supra* note 16, at 22-25.

<sup>270</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26.

<sup>271</sup> See *id.* The difference between mandatory and automatic information exchange is similar to that between *ex ante* and *ex post* information acquisition in the domestic context. Automatic information exchange occurs when at specified times each partner provides information meeting conditions established in advance. The 1939 U.S.-Sweden Treaty provides an excellent illustration of automatic information exchange. See U.S.-Sweden 1939 Treaty, *supra* note 210, art. XVI. By contrast, mandatory information exchange requires a request. See U.S. 2006 Model Convention, *supra* note 16, art. 26(4).

bound to satisfy any requests.<sup>272</sup> On the other hand, the model language does not require information to be provided automatically.<sup>273</sup> By contrast, the 1927 and 1946 models mandated extensive automatic information exchange.<sup>274</sup> When the United States published its first model tax treaty in 1976, it made the mandatory approach standard.<sup>275</sup> In practice, certain kinds of information are routinely exchanged,<sup>276</sup> in some cases in electronic format,<sup>277</sup> but those exchanges take place despite the apparent absence of any formal commitment under modern bilateral tax treaties to automatically exchange information.<sup>278</sup> Automatic exchange is not expressly called for under either the current U.S. or OECD model.<sup>279</sup>

The technical explanation that accompanied the issuance of the 2006 model treaty offers some indication as to the breadth of information covered by the article and the extent to which countries' access to extraterritorial tax information has diminished in recent decades.<sup>280</sup> The explanation states that the model treaty language does not impose

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<sup>272</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26(3)(c).

<sup>273</sup> See *id.* art. 26.

<sup>274</sup> See *London & Mexico Conventions*, *supra* note 253, at 102–03; *1927 Report*, *supra* note 16, at 22–23.

<sup>275</sup> See U.S. Model Income Tax Convention (1976) art. 26, reprinted in SEVENTH ANNUAL INST. ON INT'L TAXATION 291, 341–43 (1976).

<sup>276</sup> Zagaris, *supra* note 160, at 348 (“The IRS routinely exchanges information about taxpayer receipts of ‘passive’ or investment income, such as dividends, interest, royalties, and rents. Under the program the IRS furnishes its tax treaty partners United States-based withholding information for taxpayers who claim foreign taxpayer status and who file IRS Form 1042S. From IRS Form 1042S the IRS develops IRS Form 5335 that it furnishes to the treaty partners.”)

<sup>277</sup> OECD MANUAL, *supra* note 24, ¶¶ 4–13.

<sup>278</sup> For years, prior to the adoption of new withholding regulations in 2001, the United States unilaterally obligated itself to provide extraterritorial tax information to jurisdictions with which it had treaty relationships. See Treas. Reg. § 1.1461-2(d) (1984); 49 Fed. Reg. 36,830, 36,835 (1984) (“If a foreign country has entered into an income tax treaty with the United States which provides for the mutual exchange of information, the Commissioner shall, as soon as practicable after the close of a calendar year during which the treaty is in effect, transmit to the appropriate authority designated in the treaty with that country the information contained in Forms 1042S showing a payee with an address in the country.”). The current regulations do not include such a commitment. See Treas. Reg. § 1.1461-2 (as amended in 2005). It is striking that at a time when it actively sought increased information from other nations, the United States would eliminate such a provision. See *id.*

<sup>279</sup> In other words, each creates an obligation to supply relevant information, but does not specify precisely what information must be provided or when it must be provided. See U.S. 2006 Model Convention, *supra* note 16, art. 26(1) (“shall exchange such information as may be relevant”); OECD 2005 Model Tax Convention, *supra* note 16, art. 26(1) (“shall exchange such information as is foreseeably relevant”).

<sup>280</sup> See U.S. 2006 MODEL TREATY TECHNICAL EXPLANATION, *supra* note 250, at 86–90.

an obligation to provide general financial information such as bank records pertaining to residents of a treaty partner, but requires a specific showing that any information requested is in fact necessary to enforce taxes.<sup>281</sup> Obviously, it is not surprising that U.S. tax authorities have less access to extraterritorial tax information under the model treaty than they do in the domestic context.<sup>282</sup> Far more striking is that the model treaty prevents U.S. tax authorities from even requesting ex post information that they would have received on an ex ante basis under the 1939 U.S.-Sweden treaty.<sup>283</sup>

Taking a step back from the details of these agreements, it becomes clear that the information exchange provisions of today's double tax treaties are important because of their ubiquity rather than their utility.<sup>284</sup> Even the most potent of today's information exchange provisions fails to measure up to the benchmark established by the League of Nations in the 1920s. Although they do provide authorities with useful extraterritorial investigative powers,<sup>285</sup> particularly with

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<sup>281</sup> See *id.* at 86. ("[T]he language 'may be' would not support a request in which a Contracting State simply asked for information regarding all bank accounts maintained by residents of that Contracting State in the other Contracting State, or even all accounts maintained by its residents with respect to a particular bank.").

<sup>282</sup> Compare U.S. 2006 Model Convention, *supra* note 16, art. 26 (providing for exchange of specific information which "may be relevant"), with I.R.C. §§ 6041-6042, 6111 (2000 & Supp. V 2005) (requiring broad and varied types of third-party reporting).

<sup>283</sup> Compare U.S.-Sweden 1939 Treaty, *supra* note 210, art. XVI, with U.S. 2006 Model Convention, *supra* note 16, art. 26. One explanation for limitations of modern information exchange provisions is a concern for privacy and taxpayer rights. The tension is evident in recent changes to the OECD model treaty. The OECD narrowed the information exchange article of its model double tax treaty by replacing the word "necessary" with the phrase "foreseeable relevant." COMMENTARY ON THE ARTICLES OF THE 2005 OECD MODEL INCOME AND CAPITAL TAX CONVENTION, art. 26 ¶ 4.1 [hereinafter 2005 OECD COMMENTARY], reprinted in OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION—2005 & KEY TAX FEATURES OF MEMBER COUNTRIES 2006, at 313 (Tiago Cassiano Neves ed., 2006). The OECD explained that

[t]he standard of "foreseeable relevance" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

*Id.* ¶ 5.

<sup>284</sup> See Graetz, *supra* note 216, at 1358 (estimating the existence of more than 1700 bilateral double tax treaties).

<sup>285</sup> Although treaty information exchange provisions favor ex post information acquisition, it should be noted that even those investigative powers are more limited than their domestic counterparts. Compare *United States v. Luther*, 481 F.2d 429, 432 (9th Cir. 1973) (permitting domestic fishing expeditions), with 2005 OECD COMMENTARY, *supra* note 283, ¶ 5 (prohibiting extraterritorial fishing expeditions).

respect to ex ante information reporting, they fall well short of the results an ideal system might achieve.<sup>286</sup> Instead, the significance of these information exchange provisions is primarily a function of how pervasive double tax treaties have become. Because there are so many double tax treaties,<sup>287</sup> and because nearly all of them contain information exchange provisions based on one of the leading models, it would not be unreasonable to conclude that they are responsible for the bulk of the extraterritorial tax information countries receive.

As a result, the limitations of these arrangements pose a key obstacle to closing what is sometimes referred to as the international tax gap.<sup>288</sup> One may easily grasp their first major shortcoming, the relatively modest level of information flows they require, by comparing today's treaties with the relatively bold requirements of earlier agreements. The second principal downside is also in part a product of the "second-fiddle" role information exchange plays in these treaties.<sup>289</sup> Because their primary purpose is to limit duplicative taxes on international commerce, bilateral double tax treaties are far more likely to exist between pairs of countries with strong commercial ties and large amounts of cross-border investment.<sup>290</sup> Because information flows do not always mirror commercial ties, the significant gaps that exist in the global network of double tax treaties meaningfully inhibit the flow of useful extraterritorial tax information even while the impact of those gaps on cross-border commerce is relatively modest. Partly in response to those shortcomings, in recent years, efforts to increase access to extraterritorial tax information has led to a revival of the League of Nations' concept of stand-alone administrative assistance agreements.

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<sup>286</sup> The kinds of specific, targeted information U.S. tax authorities rely on domestically, such as ex ante OID and tax shelter reporting by third parties, bears almost no resemblance to the unwieldy bulk taxpayer information transfers that take place within the OECD. See generally OECD MANUAL, *supra* note 24, ¶¶ 4–17. Those transfers have been criticized as woefully inadequate, and obviously fall far short of what U.S. tax authorities receive from domestic sources. See Zagaris, *supra* note 160, at 349 ("The problem with automatic exchanges is that they are so voluminous and occur years after the filing of the returns. Moreover, they are often in foreign languages and in forms that are not consistent among revenue authorities. These circumstances make automatic exchanges of information difficult, time-consuming, and expensive to use.").

<sup>287</sup> See Graetz, *supra* note 216, at 1358.

<sup>288</sup> See Guttentag & Avi-Yonah, *supra* note 157, at 100–01, 105.

<sup>289</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26 (providing for information exchange within bilateral double taxation treaties); OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>290</sup> See Allison D. Christians, *Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study*, 71 BROOK. L. REV. 639, 641 (2005) (noting that "there are currently no treaties in force between the United States and any of the LDCs in Sub-Saharan Africa.").

### 3. Other Information Exchange Arrangements

Because of the limitations of the double tax treaty as a mechanism for acquiring extraterritorial tax information and the increasing importance of this information, specialized administrative assistance treaties have reemerged over the past few decades.<sup>291</sup> By the 1980s, the inadequacy of then-available approaches, essentially limited to the information exchange articles embedded in double tax treaties and unilateral efforts, had become apparent.<sup>292</sup> Governments with a growing appetite for extraterritorial tax information responded by creating variations on the basic information exchange concept.<sup>293</sup> The United States initiated a policy of entering into treaties that consisted of just an exchange of information article and little else.<sup>294</sup> On a parallel track, the OECD also revived and updated the League of Nations' series of draft administrative assistance conventions.<sup>295</sup>

The creation of the stand-alone tax information exchange agreement ("TIEA") came in response to a 1981 U.S. report on tax evasion.<sup>296</sup> That report highlighted the ease with which U.S. taxpayers were able to engage in tax flight.<sup>297</sup> It suggested that TIEAs could make tax flight more difficult by helping to close the gap left by the United States' reliance on a network of double tax treaties that failed to include most of the jurisdictions the United States considered tax havens.<sup>298</sup> By gaining access to extraterritorial tax information from tax havens, the United States hoped it could more easily investigate U.S. tax cheats.<sup>299</sup>

Although the TIEAs were structured as symmetrical agreements, giving each country access to information from the other, access to extraterritorial tax information was much more important to the United

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<sup>291</sup> See Zagaris, *supra* note 160, at 333-34.

<sup>292</sup> See *id.*

<sup>293</sup> See *id.*

<sup>294</sup> See *id.*

<sup>295</sup> Convention on Mutual Administrative Assistance in Tax Matters, Council of Eur.-Organization for Economic Cooperation and Development, Jan. 25, 1988, 1966 U.N.T.S. 216 [hereinafter COE/OECD 1988 Convention], available at [http://untreaty.un.org/unts/120001\\_144071/17/9/00014362.pdf](http://untreaty.un.org/unts/120001_144071/17/9/00014362.pdf).

<sup>296</sup> See RICHARD A. GORDON, DEP'T OF TREASURY, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 212 (1981); see also Zagaris, *supra* note 160, at 333-34 (discussing influence of the 1981 report).

<sup>297</sup> See GORDON, *supra* note 296, at 32-37.

<sup>298</sup> See *id.* at 212.

<sup>299</sup> See *id.* at 212-13 (making recommendations to improve information exchange); Zagaris, *supra* note 160, at 333-34.

States than to its potential counterparties.<sup>300</sup> To provide an incentive for nations that had little interest in receiving information to enter into information exchange agreements, the United States chose to grant preferred status to participating countries.<sup>301</sup> That preferred status provides several benefits for a TIEA counterparty, including making it easier for U.S. taxpayers attending conventions in that jurisdiction to deduct expenses related to the convention.<sup>302</sup> The existence of those benefits presumably encouraged countries to at least enter into TIEAs.<sup>303</sup> As a result, the U.S. TIEA initiative enjoyed some success;<sup>304</sup> it failed, however, to provide a silver bullet for the tax flight problem.<sup>305</sup>

During the same time period, the OECD published its first model convention focusing on the collection, as opposed to the reduction, of taxes.<sup>306</sup> The 1981 OECD Model Administrative Assistance Convention

<sup>300</sup> In connection with a recent OECD initiative to create stand-alone tax information exchange agreements with tax havens, a U.N. report noted that "[i]t is not very significant that under the OECD Model TIEA, a cooperative tax haven jurisdiction . . . can request information from an OECD country . . . because . . . tax haven jurisdictions generally impose no or low income taxes" and "would not be requesting any such information from the OECD source country." U.N. Ad Hoc Group of Experts on Int'l Cooperation in Tax Matters, *Tax Treatment of Cross-Border Interest Income and Capital Flights: Recent Developments*, ¶ 52, U.N. Doc. ST/SG/AC.8/2003/L.10 (Dec. 15–19, 2003) [hereinafter U.N. Tax Experts Report], available at <http://daccessdds.un.org/doc/UNDOC/LTD/N03/427/20/PDF/N0342720.pdf?OpenElement>.

<sup>301</sup> See I.R.C. § 274(h)(6) (2000); Cynthia Blum, *Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?*, 6 FLA. TAX REV. 579, 596 (2004); see also H.R. REP. 98-266, at 28–29 (1983), as reprinted in 1983 U.S.C.C.A.N. 643, 669–70 ("The committee believes that the favorable convention treatment should be available only to those countries which are willing to assist the United States in enforcing its tax laws. Accordingly, the convention deduction is made available only for conventions in a country that enters into an exchange of information agreement with the United States."). Section 274(h)(6) was added in 1983. Pub. L. No. 98-67, § 222, 97 Stat. 369, 395 (1983).

<sup>302</sup> See I.R.C. § 274(h)(6) (treating eligible Caribbean countries as part of the North American area and therefore eligible to host tax deductible conventions).

<sup>303</sup> There is, of course, a big difference between entering into a treaty and wholeheartedly embracing it. See Oona A. Hathaway, *Between Power and Principle: An Integrated Theory of International Law*, 72 U. CHI. L. REV. 469, 514–19 (2005) (discussing tendency of many countries not to comply with treaties into which they enter). Professor Hathaway notes that "collateral consequences of treaty membership can sometimes lead states with poor practices to commit to but not comply with a treaty." *Id.* at 514.

<sup>304</sup> Barbados was the first to enter into a TIEA with the United States. Blum, *supra* note 301, at 600 n.69. Over the next few years, some other countries followed suit. *Id.*

<sup>305</sup> Recent estimates have put the amount of U.S. tax revenues lost to tax havens as high as \$70 billion per year. STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS, U.S. TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS, & SECRECY 1 (Comm. Print 2006), available at [http://hsgac.senate.gov/\\_files/TAXHAVENABUSESREPORT8106FINAL107.pdf](http://hsgac.senate.gov/_files/TAXHAVENABUSESREPORT8106FINAL107.pdf). That estimate far exceeds the estimated \$10 to \$15 billion in revenue losses attributable to tax shelters each year. See Sawicky, *supra* note 6, at 4–6.

<sup>306</sup> OECD 1981 MODEL CONVENTION, *supra* note 140, at 11.



proposed a framework for multilateral enforcement assistance with respect to taxes.<sup>307</sup> That document consciously drew on the work of the League of Nations from the 1920s and 1940s as the OECD had previously done in producing its 1963 model double tax treaty.<sup>308</sup> The 1981 model called on participating countries to "provide assistance to each other in the recovery of tax claims and in the service of documents."<sup>309</sup>

The drafters of the convention noted that administrative assistance had previously been addressed in its 1963 model double tax treaty, "though in a less comprehensive way than the model conventions of the League of Nations"<sup>310</sup> and noted that by the early 1980s, "tax evasion ha[d] become a matter of increasing concern for governments which have considered the issue both at a bilateral level and in international organisations."<sup>311</sup> The multilateral agreement was intended to provide tax authorities with the tools necessary to operate effectively in an increasingly global economy.<sup>312</sup>

Despite the perceived urgency of its mission, the 1981 model represented a relatively small step. Unlike the London and Mexico administrative assistance drafts, it addressed only the collection of taxes already assessed.<sup>313</sup> The treaty that went into force in 1988, however, went further. Rather than facilitating only the collection of taxes, it called on signatories to "exchange any information . . . that is foreseeably relevant to the assessment and collection of tax, and the recovery and enforcement of tax claims . . . ."<sup>314</sup> Nevertheless, like the 1981 draft,<sup>315</sup> the 1988 treaty did not require the general automatic exchange of informa-

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<sup>307</sup> See *id.*

<sup>308</sup> *Id.* at 4-5.

<sup>309</sup> *Id.* at 11.

<sup>310</sup> *Id.* at 5.

<sup>311</sup> OECD 1981 MODEL CONVENTION, *supra* note 140, at 5.

<sup>312</sup> See *id.* Tax authorities perceived the need for such an agreement because "[t]he increase in international movement of persons, capital, goods and services ha[d] considerably widened the scope of taxpayers' noncompliance . . . ." *Id.*

<sup>313</sup> The 1981 model was intended to fill a gap left by the 1977 model double tax treaty. See *id.* ("During the preparatory work that led to the 1977 Model Convention for the avoidance of double taxation the Committee on Fiscal Affairs . . . decided at that time just to revise Article 26 on assistance in assessment, but to initiate work on the drafting of a separate model convention on mutual administrative assistance in the recovery of taxes.").

<sup>314</sup> COE/OECD 1988 Convention, *supra* note 295, art. 4(1).

<sup>315</sup> The commentary to the 1981 model merely noted that "Contracting States which wish to do so are free to provide for automatic . . . exchange . . . ." See OECD 1981 MODEL CONVENTION, *supra* note 140, at 31.

tion, and allowed parties to arrange automatic exchanges at a later date.<sup>316</sup>

The U.S. TIEAs and the OECD multilateral convention offer two lessons regarding extraterritorial tax information acquisition. First, they demonstrate that the pressures that have drawn attention to the need for improved access to extraterritorial tax information over the last few years are not new.<sup>317</sup> Second, they suggest that the time may have come to revisit the basic assumptions that underlie eighty years of efforts to facilitate the acquisition of extraterritorial tax information. The weakened barter system in its current state does not provide even the information thought necessary to enforce the income tax in 1927. In today's even more complicated world, it may be that the barter framework is itself inadequate. The OECD and tax haven TIEA examples particularly suggest structural problems with the barter model if neither a group as homogenous as the OECD nor relationships as imbalanced as those between the United States and its tax haven TIEA counterparties could use the framework successfully.

### C. The Failure of the Barter System

In the 1920s, the income tax was not a "mass tax" but was instead paid by a relatively small segment of the population.<sup>318</sup> Attitudes towards taxpayer privacy were less settled than they are today.<sup>319</sup> Esoteric concepts such as OID lay decades into the future.<sup>320</sup> At the same time, barriers to trade and currency controls imposed powerful limits on

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<sup>316</sup> The treaty provided that "[w]ith respect to categories of cases and in accordance with procedures which they shall determine by mutual agreement, two or more Parties shall automatically exchange . . . information . . . ." COE/OECD 1988 Convention, *supra* note 295, art 6.

<sup>317</sup> That renewed attention is exemplified by recent U.S. and OECD efforts to establish new Tax Information Exchange Agreements. See Zagaris, *supra* note 160, at 332-57.

<sup>318</sup> During the interwar period, the income tax was an important feature of the fiscal landscape but had not yet assumed the central role it would take after the Second World War. See BROWNLEE, *supra* note 23, at 89, 96-97.

<sup>319</sup> Despite good reasons to think that it would have a positive impact on tax compliance, tax publicity (making summary tax data for each taxpayer public) appears to be viewed as inconsistent with accepted standards of taxpayer privacy. See Zagaris, *supra* note 160, at 380-81 (arguing for stronger protections for taxpayer privacy in information exchange provisions). In the nineteenth and early twentieth century, it was far from clear whether tax publicity would be acceptable. See generally Marjorie Kornhauser, *Shaping Public Opinion and the Law in the 1930s: How a "Common Man" Campaign Ended a Rich Man's Law* (Tulane Univ. Sch. of Law, Pub. Law & Legal Theory Research Paper Series, Research Paper No. 06-02, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=880383](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880383) (describing history of tax publicity provisions).

<sup>320</sup> See Tax Reform Act of 1969, Pub. L. No. 91-172, § 413, 83 Stat. 487, 609.

the ability of individuals and businesses to engage in cross-border activity.<sup>321</sup> By the 1980s, when countries like the United States and organizations like the OECD began to recognize the importance of extraterritorial tax information, the income tax had become a very different animal, and the world in which income taxes are paid had completely changed.<sup>322</sup> One of the consequences of those transformations is that the barter system that countries have long relied on to acquire extraterritorial tax information does not appear to be capable of meeting their needs.<sup>323</sup> In particular, countries like the United States have seen a growing disparity between the often useful information they are able to acquire domestically and the increasingly useless information they acquire from abroad.<sup>324</sup>

For any barter system to succeed, each party must be prepared to exchange a commodity valued by the other.<sup>325</sup> Moreover, the legs of the transaction must be roughly equal in value. Those limitations help to explain why the United States felt it necessary to stretch the "information exchange" concept by inserting what U.S. tax law generally refers

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<sup>321</sup> See Tanzi, *supra* note 197, at 176-77.

<sup>322</sup> See, e.g., GORDON, *supra* note 296, at 8-9, 212-213; Tanzi, *supra* note 197, at 176-77.

<sup>323</sup> It is certainly possible that no system of extraterritorial tax information acquisition would fare better than information exchange. Isolated successes like the U.S.-Sweden treaty discussed earlier are arguably largely a product of the unique historical circumstances in which they occurred. See *supra* note 263 (reviewing history leading up to U.S.-Sweden treaty). Public choice theory suggests that extraterritorial tax acquisition efforts will always fare relatively poorly. Given that the costs of creating a comprehensive extraterritorial tax information acquisition regime would likely have fallen on a smaller group than the costs of its domestic counterpart (i.e., only those involved in cross-border commerce) while the benefits would have been equally diffuse, efforts to collect extraterritorial tax information should be less successful than efforts to collect domestic tax information. See Shaviro, *supra* note 122, at 6-7.

<sup>324</sup> The broad access to domestic information is illustrated by the information acquisition regimes described in Part I. See *supra* notes 48-130 and accompanying text. By contrast, the information received from abroad is less useful. See Zagaris, *supra* note 160, at 349 (criticizing bulk taxpayer information exchange as voluminous and often outdated); Everson Letter, *supra* note 188, at 2 (citing lack of taxpayer identification numbers as one of the key problems to making effective use of existing information exchange agreements).

<sup>325</sup> See DICTIONARY OF THE SOCIAL SCIENCES, *supra* note 29, at 33 (defining "barter"). Students of the U.S. income tax need look no further for proof than the rules governing tax-free exchanges of business and investment property. See I.R.C. § 1031 (2000 & Supp. V 2005). If those rules did not create a great deal of flexibility by allowing taxpayers to use "boot" to even lopsided exchanges and to use techniques such as "delayed" or "three-cornered" exchanges, a far smaller number of "barter" transactions would qualify for the favorable tax treatment afforded by the Internal Revenue Code. See Bradley T. Borden, *Reverse Like-Kind Exchanges: A Principled Approach*, 20 VA. TAX REV. 659, 685-87 (2001) (describing flexibility in requirements for § 1031 exchange transactions).

to as "other property"<sup>326</sup> in the form of unrelated tax preferences, into the purported information swap conducted pursuant to its TIEAs. It is, after all, obvious that the notion of an even "exchange" of information between tax flight jurisdictions and tax havens is nothing more than a convenient fiction.<sup>327</sup> Recalling the hypothetical neighbors described above may help to illustrate the source of the imbalance.<sup>328</sup> Quite simply, the United States—the quintessential large, wealthy jurisdiction—needed far more extraterritorial tax information than its neighbor.

The same basic asymmetry problem goes a long way towards explaining why the barter system for information exchange has not proven particularly effective even among pairs and groups of relatively similar countries. A successful swap of extraterritorial tax information between a pair of jurisdictions would require each country to expect roughly the same amount of benefit from the information it hopes to receive. If their expectations are significantly different, there is a risk that the information exchange will satisfy only the party with the lower expectations or that no exchange will take place at all.<sup>329</sup> The country that expects to derive a relatively small benefit from the exchange will be willing to devote only a relatively small amount of resources to acquiring and providing information. The information-hungry partner would be theoretically willing to devote more resources to receive more or higher quality information, but under the barter system cannot derive any additional benefit in return for those extra efforts.

The asymmetry problem is exacerbated by the requirement in existing bilateral agreements that the consideration used must not merely be extraterritorial tax information, but reciprocal extraterritorial tax information.<sup>330</sup> Because of that constraint, even jurisdictions that would

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<sup>326</sup> See, e.g., L.R.C. § 1031(b). The informal term for other property is "boot." See Borden, *supra* note 325, at 716.

<sup>327</sup> See U.N. Tax Experts Report, *supra* note 300, ¶ 52 (noting the insignificance of information received from tax flight jurisdictions by tax havens).

<sup>328</sup> See *supra* notes 196–205 and accompanying text.

<sup>329</sup> For example, if one country expects to increase its tax revenues by \$100 million by receiving information from a potential information exchange partner that would cost \$10 million to generate, while the partner might only increase its revenues by a few million dollars if it received extraterritorial tax information from the first country, the information exchange might not take place if tax information is the only permissible consideration.

<sup>330</sup> The "reciprocal" requirement further restricts the consideration that may be used to acquire information that is useful to each jurisdiction and that each jurisdiction can supply. See, e.g., 2005 OECD COMMENTARY, *supra* note 283, art 26 ¶ 18 (noting that "if the structure of the information systems of two Contracting States is very different, the conditions under [paragraph 3 of Article 26 of the 2005 Model OECD Convention] will lead to the result that the Contracting States exchange very little information or perhaps none at all."); see also 1927 Report, *supra* note 16, at 24 ("First of all [assistance] must be reciprocal,

place an identical value on their desired extraterritorial tax information might be unable to reach a fully satisfactory arrangement. If the extraterritorial tax information each needs is significantly different, they will only be able to agree to exchange those limited items of information that they both need and have the capacity to provide.<sup>331</sup> If one country depends heavily on *ex ante* information reporting while another relies on *ex post* information, the former might prefer to receive a steady stream of information automatically while the latter might prefer simply having access to information on an as-needed basis. The reciprocity requirement could easily block the creation of such an arrangement.

Fortunately, the use of a barter regime for extraterritorial tax information acquisition is not the only possible approach. The recent European Union Savings Directive (the "Directive") illustrates one possible alternative.<sup>332</sup> The Directive leverages the supranational bureaucracy of the European Union to compel members to provide *ex ante* information to one another.<sup>333</sup> But because governments use extraterritorial tax information to generate tax revenue, creating a supranational tax authority is not the only alternative to the use of the dominant barter model. If a given country could estimate the benefits it expects to derive from the receipt of extraterritorial tax information from a potential partner, it would be able to put a price tag on that information.<sup>334</sup> Even if the government in possession of, or at least with access

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that is to say, States will be bound to afford each other assistance only under identical conditions; in other words, subject to any provision to the contrary, a country will only be entitled to demand information of a kind which it is itself in a position to supply.").

<sup>331</sup> This dynamic could help to explain why it is easier to reach agreement on providing tax information on request than it is to reach agreement with respect to automatic exchange of information. The 1988 OECD treaty, for example, encouraged, but did not require, automatic exchanges of information. See COE/OECD 1988 Convention, *supra* note 295, art 6. It could also explain why "most of the existing [U.S.-tax haven] agreements are restricted only to criminal matters." Guttentag & Avi-Yonah, *supra* note 157, at 105. Criminal matters may be the only context in which U.S. and tax haven interests are aligned.

<sup>332</sup> Council Directive 2003/48, 2003 O.J. (L 157) 38 (EC), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:157:0038:0048:EN:PDF> (amended by Council Directive 2004/66, 2004 O.J. (L 168); Council Directive 2004/587, 2004 O.J. (L 257) 7 (EC); Council Directive 2006/98, 2006 O.J. (L 363) 129 (EC)).

<sup>333</sup> See Cathy Phillips, *The EU Savings Tax Directive: A Work in Progress*, 42 TAX NOTES INT'L 1011, 1013 (2006).

<sup>334</sup> In the domestic context, such revenue estimates are conducted as a matter of course when tax policy changes are being considered. The Office of Tax Analysis within the U.S. Treasury Department has a Revenue Estimating Division that "estimates the revenue consequences of all the Administration's legislative tax proposals and major Congressional tax proposals." U.S. Dep't of the Treasury, Office of Tax Policy, Divisions of the Office of Tax Analysis, <http://www.ustreas.gov/offices/tax-policy/offices/otadivisions.shtml> (last visited

to, the sought-after extraterritorial tax information had no need for reciprocal extraterritorial tax information, it might be willing to sell that information for cash.

Put differently, might the global market for extraterritorial tax information function more effectively if it were more complete? If we assume that each country's extraterritorial tax information needs are unique, it stands to reason that eliminating (1) the requirement that information exchange be reciprocal<sup>335</sup> and (2) the implicit prohibition on using consideration other than extraterritorial tax information<sup>336</sup> would increase the likelihood that countries will succeed in acquiring the extraterritorial tax information they need. On the other hand, the problem may not be too little market, but too much. Perhaps pursuing an alternative, nonmarket approach, such as modifying tax systems to reduce the need for extraterritorial tax information or creating a transnational quasi-governmental body capable of maintaining and enforcing a system to ensure that each government receives the information it needs, would be preferable. The next Part describes several options and compares the costs and benefits of either creating a more complete market or of eliminating the need for a market in extraterritorial tax information.

#### IV. A MORE COMPLETE MARKET OR NO MARKET AT ALL?

Given how inadequate the practice of information exchange has proven, it is somewhat surprising that the concept has retained such a strong appeal for scholars<sup>337</sup> and policymakers.<sup>338</sup> The reason for its

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Feb. 28, 2008). Separately, the nonpartisan, congressional Joint Committee on Taxation provides the official revenue estimates of all tax legislation that is considered by Congress. U.S. Congress Joint Comm. on Taxation, Joint Committee Revenue Estimation Process, <http://www.house.gov/jct/revhist.htm> (last visited Feb. 28, 2008). Individual members of Congress may make requests for revenue estimates of particular tax proposals. *Id.*

<sup>335</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>336</sup> See *supra* note 240 and accompanying text. One important respect in which the information exchange provision of a bilateral double tax treaty is different from a stand-alone agreement is that the double tax treaty creates more opportunities for horse-trading, effectively loosening the reciprocity constraint. Even if each provision of a treaty is reciprocal, it seems likely that some provisions would provide more benefit to one treaty partner than to the other. Obviously, the flexibility the opportunity to trade provisions creates is not unlimited.

<sup>337</sup> See, e.g., Guttentag & Avi-Yonah, *supra* note 157, at 106 (advocating continued efforts to expand the network of "bilateral information exchange agreements based on the OECD model").

<sup>338</sup> See Zagaris, *supra* note 160, at 332-57 (discussing recent efforts to establish new TIEAs).

longevity may simply be path dependence,<sup>339</sup> a product of the coattails of its more successful sibling (the double tax treaty),<sup>340</sup> or something else entirely. Whatever the explanation, it may finally be time to turn away decisively from information exchange. This Part begins by laying out three strategies for improving the fit between countries' needs for extraterritorial tax information and their ability to acquire it.<sup>341</sup> It then evaluates those possible approaches by considering their impact on aggregate social welfare, their distributional implications, and their likely effect on privacy and information control.<sup>342</sup>

### A. Closing the Extraterritorial Tax Information Deficit

The basic choice confronted by countries without access to the extraterritorial tax information they need is a simple one. Countries can either work to create a more complete market for extraterritorial tax information or they can choose to reduce their reliance on that market. This Section focuses on the practical implications of that choice.<sup>343</sup> It first sketches out the broad outlines of a more complete market for extraterritorial tax information and then explores two nonmarket alternatives.<sup>344</sup>

#### 1. A More Complete Market

When U.S. tax authorities collect tax information domestically, they have broad authority but are still subject to meaningful constraints.<sup>345</sup> Of course, those constraints are different from those they encounter in collecting extraterritorial tax information.<sup>346</sup> They possess the authority to demand virtually any tax information from private parties without the need to provide compensation.<sup>347</sup> Still, political realities limit their ability to acquire any and all information that might be help-

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<sup>339</sup> See *supra* notes 206–336 and accompanying text (tracing development of information exchange provisions).

<sup>340</sup> See Graetz, *supra* note 216, at 1358 (estimating the existence of more than 1700 bilateral double tax treaties).

<sup>341</sup> See *infra* notes 345–377 and accompanying text.

<sup>342</sup> See *infra* notes 378–411 and accompanying text.

<sup>343</sup> See *infra* notes 345–377 and accompanying text.

<sup>344</sup> See *infra* notes 345–377 and accompanying text.

<sup>345</sup> See Brown, *supra* note 124, at 807 (discussing end of TCMP due to political pressures).

<sup>346</sup> See Tillinghast, *supra* note 8, at 39, 51.

<sup>347</sup> See I.R.C. §§ 7601–7613 (West 2002 & Supp. 2007) (authorizing various investigative and enforcement powers of IRS including summons and power to execute search and arrest warrants, among others).

ful.<sup>348</sup> When policymakers designed the systems to acquire OID and tax shelter information discussed above,<sup>349</sup> for example, they had to decide precisely what information was absolutely necessary and who should supply it. The goal was not to collect the greatest amount of information possible, but rather the smallest amount that would facilitate the necessary observation.

These same choices would need to be made if tax authorities were purchasing information from other tax authorities (and indirectly from private parties within each foreign jurisdiction).<sup>350</sup> If U.S. tax authorities were to bargain with foreign governments for the right to receive information with respect to income earned by U.S. taxpayers, for example, through foreign corporations treated as QEFs,<sup>351</sup> the U.S. authorities would need to decide what information to acquire and from whom. Having identified those jurisdictions in which U.S. taxpayers earn significant quantities of QEF income (or OID income or any other income U.S. taxpayers earn in significant amounts overseas), the United States could negotiate with the governments of those jurisdictions regarding the specific nature of the information each might be willing to provide, and, if necessary, acquire, as well as regarding the price at which it would be willing and able to provide it.

Each such negotiation would be conducted against the background of the administrative capacity and privacy constraints of the host states. The tax authorities of some of those states might already collect much of the information in question and have the ability to easily provide precisely the information sought. Others might be bound by stringent privacy laws that would prevent the wholesale disclosure of information, but might nevertheless be able to work with U.S. authorities to create a system that would identify potential compliance failures.<sup>352</sup> The negotiated price would likely include both an amount that

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<sup>348</sup> For example, eliminating the "book/tax" prong of the reportable transaction definition, *see supra* note 80, may have been justified as a policy matter, but also may have resulted in part from pressure to ensure that the rules imposed as few burdens on taxpayers and their advisors as was possible. Likewise, the demise and rebirth of the TCMP, *see supra* notes 124–125, illustrate the sensitivity of tax authorities to political pressures. *See also* Blum, *supra* note 25, at 629 (noting that countries' taxation decisions require consensus about the services the government provides and their distribution).

<sup>349</sup> *See supra* notes 59–85 and accompanying text.

<sup>350</sup> A different, more radical approach would be to purchase the necessary information from private actors, including foreign businesses and banks.

<sup>351</sup> *See supra* notes 201–204.

<sup>352</sup> Rather than simply creating a one-way flow of information, it might be necessary for U.S. authorities to provide information to the QEF host jurisdiction which could then compare it to information in its possession for discrepancies, which it could bring to the



would compensate private parties, such as the QEFs themselves, for expenses they incur, and a component intended to offset the burdens imposed on the participating foreign governments.

Although a useful illustration of the sort of *ex ante* information that could be acquired, third-party information with respect to QEF income earned by U.S. taxpayers is almost certainly not the most urgent priority for U.S. tax authorities.<sup>353</sup> It is also undoubtedly true that the tax laws of many other jurisdictions have no concept even remotely similar to the QEF and would have nothing to gain from a reciprocal effort to acquire that information.<sup>354</sup> Even if this information was neither a priority nor a reciprocal need, so long as an initiative to purchase that information could generate enough tax revenue to more than pay for the cost of its acquisition, such an effort could be worthwhile.

The wide variation among national tax systems would make it inevitable that each country would benefit from a different mix of extraterritorial tax information.<sup>355</sup> Take, for example, the pair of hypothetical neighboring countries described above.<sup>356</sup> The smaller of the two would need consumption- rather than income-related extraterritorial tax information and would be less likely to need it on an *ex ante* basis.<sup>357</sup> Others that impose taxes on wages and, unlike the United States do not exempt wages earned overseas,<sup>358</sup> might benefit from receiving third-party reports regarding taxpayers employed overseas. For some countries, there might not be any extraterritorial tax information that

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attention of U.S. tax authorities. Such an arrangement could help the United States achieve its enforcement objectives while allowing the foreign jurisdiction to maintain the integrity of its privacy laws.

<sup>353</sup> International tax shelters, for example, might be a higher priority. The United States has begun cooperating with other countries in just such an effort to combat international tax shelters. See Joint International Tax Shelter Information Centre Memorandum of Understanding, available at <http://www.irs.gov/pub/irs-utl/jitsic-finalmou.pdf> (last visited Feb. 27, 2008).

<sup>354</sup> See Kimberly S. Blanchard, *Cross-Border Tax Problems of Investment Funds*, 60 TAX LAW. 583, 593 (2007) (noting very few other countries utilize QEF election regime).

<sup>355</sup> See Ring, *supra* note 65, at 88–89 (discussing variation in international tax rules).

<sup>356</sup> See *supra* notes 196–205 and accompanying text.

<sup>357</sup> It is interesting to consider exactly what extraterritorial tax information countries that rely heavily on import taxes might find helpful in taxing overseas purchases by residents. Credit card information with respect to foreign purchases would be helpful, but it is unclear whether countries would be willing to collect and supply that information to other nations.

<sup>358</sup> See I.R.C. § 911 (West Supp. IV 2008) (amended by Pub. L. No. 110-172, 121 Stat. 2476 (2007)) (allowing U.S. citizens to earn a certain amount and type of income without being subject to U.S. tax).

would be worth its cost. As a result, an optimal flow of extraterritorial tax information would likely be highly asymmetric, both in content and in volume. This asymmetry clearly contrasts with the current information exchange mandate in existing agreements.<sup>359</sup>

## 2. Nonmarket Approaches

Even if the incomplete global market for tax information leaves much to be desired, it does not necessarily follow that a more complete market presents the most appealing alternative. If, for example, the original arguments in favor of a market model, such as the "risk of" a more centralized, bureaucratic approach "appearing in some quarters as an extension beyond national frontiers of an organized system of fiscal inquisition"<sup>360</sup> are no longer the most compelling, a market approach may no longer be justified. Particularly if market failures, such as bilateral monopoly,<sup>361</sup> would impede the emergence of a robust market, it may be that moving further from a market framework might offer more benefits at less cost. The following discussion will consider two strategies that could help to close the extraterritorial tax information deficit by either improving the cross-border flow of extraterritorial tax information without relying on market principles or by decreasing the need for extraterritorial tax information.

The first possibility involves the creation of a transnational body with the power to overcome the jurisdictional problems that prevent individual governments from acquiring extraterritorial tax information unilaterally.<sup>362</sup> Such an intergovernmental actor could have power to acquire extraterritorial tax information on par with the domestic capacity of national tax authorities to acquire tax information. The second potential strategy would instead target the demand for extraterritorial tax information rather than its supply by consciously redesigning national tax systems to limit the need for extraterritorial tax information.

In recent years, two existing intergovernmental organizations, the United Nations (the "U.N.") and the OECD, have become leading con-

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<sup>359</sup> See U.S. 2006 Model Convention, *supra* note 16, art. 26; U.N. 2001 Model Convention, *supra* note 16, art. 26; OECD 2005 Model Convention, *supra* note 16, art. 26.

<sup>360</sup> 1927 Report, *supra* note 16, at 23.

<sup>361</sup> See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 3.8 (6th ed. 2003) (describing impact of bilateral monopoly on the ability of parties to strike what would be a mutually beneficial bargain). Judge Posner notes that bilateral monopoly is characterized by the fact that "neither party has good alternatives to dealing with the other." *Id.* This situation results in high transaction costs. *Id.*

<sup>362</sup> See *supra* notes 168–195 and accompanying text.

tenders for the mantle of "World Tax Organization."<sup>363</sup> In part, that is a function of activities each has conducted to advance the goal of greater international tax cooperation.<sup>364</sup> Both the OECD and the U.N. have a long history of involvement in international tax matters.<sup>365</sup> First the OECD and later the U.N. published model double tax treaties based on the older League of Nations models.<sup>366</sup> In more recent years, they have both worked to address the extraterritorial tax information deficit. The OECD first published a report on what it termed "harmful tax competition" in 1998 and has followed on that effort by initiating a new wave of information exchange agreements.<sup>367</sup> In the last few years, the U.N. Committee of Experts on International Cooperation in Tax Matters<sup>368</sup> has asserted the U.N.'s claim as the more legitimate authority on matters of international tax cooperation.<sup>369</sup>

In theory, such an organization would be able to fill the gap that lies at the heart of the extraterritorial tax information problem. Rather

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<sup>363</sup> Vito Tanzi was one of the first to address the desirability and potential role of a World Tax Organization. See generally Tanzi, *supra* note 197.

<sup>364</sup> See, e.g., U.N. Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. No. ST/ESA/102 (1980) [hereinafter U.N. Double Taxation Convention], reprinted in 5 STANLEY S. SURREY, SELECTED MONOGRAPHS ON TAXATION 87-113 (1980); OECD Double Taxation Draft, *supra* note 16.

<sup>365</sup> See, e.g., U.N. Double Taxation Convention, *supra* note 364, at 87-113; OECD Double Taxation Draft, *supra* note 16.

<sup>366</sup> See, e.g., U.N. Double Taxation Convention, *supra* note 364, at 87-113; OECD Double Taxation Draft, *supra* note 16.

<sup>367</sup> See Zagaris, *supra* note 160, at 332-57 (discussing recent efforts to establish new TIEAs). See generally 1998 OECD REPORT, *supra* note 18.

<sup>368</sup> This is the same committee formerly known as the Ad Hoc Group of Experts on International Cooperation in Tax Matters. See U.N. Fin. for Dev., Overview of the Committee of Experts on International Cooperation in Tax Matters, <http://www.un.org/esa/ffd/tax/overview.htm> (last visited Feb. 24, 2008).

<sup>369</sup> See Ad Hoc Group of Experts on Int'l Cooperation in Tax Matters, *Institutional Framework for International Tax Cooperation*, ¶¶ 5-10, U.N. Doc. ST/SG/AC.8/2003/L.6 (Aug. 19, 2003), available at <http://daccessdds.un.org/doc/UNDOC/LTD/N03/481/35/PDF/N0348135.pdf?OpenElement> ("The major industrialized countries have addressed their concerns about international taxation under the auspices of the Organisation for Economic Cooperation and Development (OECD)... The United Nations has recognized for some time the need to give the developing and transitional countries a voice in the formulation of international tax norms."). The OECD's limited membership has thus raised questions about its legitimacy. See Arthur J. Cockfield, *The Rise of the OECD as Informal "World Tax Organization" Through National Responses to E-Commerce Tax Challenges*, 8 YALE J.L. & TECH. 136, 175-86 (2006); Michael Littlewood, *Tax Competition: Harmful to Whom?*, 26 MICH. J. INT'L L. 411, 480-85 (2004). The problem proved particularly vexing in the context of its antiharmful tax competition initiative, which to some looked like a group of large, wealthy countries bullying smaller ones. See Alexander Townsend, Jr., Comment, *The Global Schoolyard Bully: The Organisation for Economic Co-Operation and Development's Coercive Efforts to Control Tax Competition*, 25 FORDHAM INT'L L.J. 215, 251-58 (2001).

than creating a patchwork bilateral solution, it would replicate on a global scale the system the European Union is working to create within Europe, in which a central authority possesses the power to compel the production of tax information and to punish noncompliance. Unfortunately, there is no international organization that appears capable of serving as the linchpin of such a regime.<sup>370</sup>

To this point, the discussion has focused exclusively on finding ways of improving access to extraterritorial tax information. A very different, and conceivably more productive, take on the problem might instead be to work to produce tax systems that consume less of it.<sup>371</sup> Although it is difficult to conceive of a tax system that would require absolutely no extraterritorial tax information,<sup>372</sup> some will inevitably require more than others. Even relatively minor alterations in tax rules, such as foreign income exclusions, could dramatically reduce the amount of extraterritorial tax information authorities need to monitor compliance.<sup>373</sup> For example, one provision of the Internal Revenue Code permits U.S. taxpayers working abroad to exclude the first \$85,700 of earned income.<sup>374</sup> There are certainly other policy justifications for the rule, but one practical implication of the exclusion is that a large number of U.S. taxpayers do not have to report any of their earned income, thereby relieving tax authorities of the obligation to verify the amount of income reported.<sup>375</sup>

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<sup>370</sup> On the one hand, the OECD probably comes the closest to having the power to form such an arrangement, but with its membership made up exclusively of large, wealthy countries, it lacks the necessary legitimacy. See Littlewood, *supra* note 369, at 480–85. On the other hand, the U.N. may have sufficient legitimacy but probably lacks the power to enforce such a regime. Hathaway, *supra* note 303, at 506, (observing that the U.N.'s enforcement authority is weak); Littlewood, *supra* note 369, at 480–85. At least in the United States, resistance to the creation of such an entity would be significant. See, e.g., Daniel Mitchell, *U.N. Tax Police Potential*, WASH. TIMES, Feb. 7, 2002, at A18.

<sup>371</sup> See Tillinghast, *supra* note 8, at 38 (noting that “[t]here is considerable scope for simplifying the international aspects of the tax law, and this would clearly make the IRS’s job easier”).

<sup>372</sup> A pure territorial tax system might come closest. It seems unlikely, however, that even such a system would require no extraterritorial tax information. Even under current law, it is the allocation of income and deductions between U.S. sources and foreign sources that is the most troublesome. See, e.g., Treas. Reg. § 1.861-8 (as amended in 2006) (requiring information about both foreign and domestic activities of taxpayers to determine how to allocate deductions).

<sup>373</sup> See I.R.C. § 911 (West Supp. IV 2008) (amended by Pub. L. No. 110-72, 121 Stat. 2476 (2007)).

<sup>374</sup> *Id.* The amount currently excludable, as adjusted for inflation, is provided by Section 3.30 of I.R.S. Rev. Proc. 2006–51, I.R.B. 2006-48.

<sup>375</sup> See I.R.C. § 911.

Unfortunately, the cross-border implications of such changes are only some of the many important policy considerations that must be taken into account. Even if it were possible to create a tax system that is significantly more efficient with respect to extraterritorial tax information, that system might fall short on other grounds. The best illustration of this may be the taxation of income derived from capital. Because that income is particularly mobile, it is also unusually elusive from tax authorities' perspective.<sup>376</sup> Abandoning efforts to tax that income would eliminate the need for a great deal of extraterritorial tax information. Such a change, however, could also produce a dramatic, and potentially undesirable, shift in tax burdens.<sup>377</sup>

### B. *Evaluating the Alternatives*

The previous Section described three strategies for reducing the disparity between the amount of extraterritorial tax information governments collect and the amount they need to enforce their tax regimes successfully. This Section assesses their relative normative merits.<sup>378</sup> It does so by focusing on three separate considerations. First, it examines their impact on aggregate social welfare. Second, it evaluates the distributional effects each approach would be likely to produce. Third, it weighs the potential consequences of each strategy for taxpayers' privacy.

#### 1. Social Welfare

The least desirable approach from the perspective of aggregate welfare<sup>379</sup> would almost certainly be to implement a tax system specifi-

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<sup>376</sup> See Avi-Yonah, *supra* note 162, at 1575–77.

<sup>377</sup> See *id.* at 1576.

<sup>378</sup> A very different question would be which approach would be the most likely to produce the desired result. Although it would be nice to assume that governments can be counted on to pursue the most normatively desirable course of action, that is no more likely to be true with respect to international tax cooperation than it is for domestic tax policy. See Dean, *supra* note 35, at 921–23. As Oona Hathaway has explained, it is possible to categorize and compare the pressures that might cause countries to both adopt and actually comply with cooperative international arrangements. See generally Hathaway, *supra* note 303.

<sup>379</sup> By using the terms social welfare and aggregate welfare, this Article intends to refer to the framework that welfare economists use for “evaluating the different choices that society may make. Under the framework, the social evaluation of a situation consists of two elements: first, determination of the utility of each individual in the situation, and second, amalgamation of individuals’ utilities in some way.” STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 595–96 (2004).

cally designed to consume only a very small amount of extraterritorial tax information. That is because such a system would inevitably sacrifice economic efficiency in the name of information efficiency. Assuming that the same total amount of tax revenue would be collected using a narrower tax base, the rates applicable to the narrower base would be higher. Those higher rates would be more likely to influence taxpayers' behavior, creating a larger wedge between the choices a given taxpayer would make in a world with and without taxes. The narrower base would give taxpayers both a greater incentive and more opportunities to engage in wasteful tax planning.<sup>380</sup>

On the other hand, creating an intergovernmental tax organization could produce a positive outcome. Ideally, by making sound choices regarding both what information should be collected and how to collect it, such an organization would help to close the extraterritorial tax information deficit without distorting taxpayers' behavior.<sup>381</sup> For example, by creating a uniform, worldwide system of providing and receiving extraterritorial tax information, it would limit taxpayers' ability to engage in tax flight by camouflaging their income.<sup>382</sup> Unfortunately, that uniformity would also be a detriment. Such an organization would need to build a broad consensus to function effectively. The one-size-fits-all solution likely to emerge from such a process might not adequately address the differing needs and concerns of the diverse group of countries involved.<sup>383</sup>

Developing a more complete market, by contrast, would offer the benefits that come along with decentralization, including providing individual countries with greater freedom to design an optimal tax system. For example, rather than being compelled to move towards a narrower tax base with higher rates, improving access to extraterritorial tax information would permit countries to maintain a broader base by taxing activities that might otherwise have been impractical.<sup>384</sup> By eliminat-

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<sup>380</sup> By simultaneously refraining from taxing one activity and taxing another more heavily, such an approach would encourage taxpayers to substitute more of the first activity in place of the second, even if the second were a more attractive option on a pretax basis.

<sup>381</sup> See *supra* notes 168–195 and accompanying text (reviewing limitations of current tax information system).

<sup>382</sup> See *supra* notes 157–167 and accompanying text (addressing tax flight).

<sup>383</sup> See *supra* notes 196–205 and accompanying text (discussing variety in countries' extraterritorial tax information needs).

<sup>384</sup> The flipside of that flexibility would be the obligation to internalize the costs of producing the necessary extraterritorial tax information. That obligation would not prevent a country from creating a tax system that consumes a great deal of extraterritorial tax information, but could make it expensive to do so. One could argue that such liberty is illusory since only relatively wealthy countries could afford to purchase extraterritorial tax

ing the need for a universal consensus created by international conventions or a supranational organization, a more flexible market approach would also create space for innovation and change.<sup>385</sup> As compared to either a demand-oriented or intergovernmental organization approach, a more complete market seems likely to produce the most desirable results in terms of its aggregate impact on welfare.<sup>386</sup>

## 2. Distributional Impact

Reducing the need for extraterritorial tax information seems likely to have mixed results in terms of its distributional impact. At the international level the distributional effects of a demand-oriented approach might be positive. If relatively wealthy countries consume a disproportionate amount of extraterritorial tax information, redirecting the resources and energy currently devoted to increasing access to that information toward problems of more relevance to poorer countries might ultimately leave those poor countries better off. At the subnational level, however, a narrow tax base would produce a tax system that favors some groups over others. If that narrow base is chosen specifically because it limits the need for extraterritorial tax information, it would tend to harm those taxpayers least likely to earn geographically mobile income or to engage in cross-border economic activity.<sup>387</sup> For example, eliminating taxes on income derived from capital would reduce the need for extraterritorial tax information but would shift the tax burden towards less geographically mobile income such as wage income, potentially making the tax system more regressive.<sup>388</sup>

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information that would not "pay for itself" by producing a substantial increase in revenues. It is not clear, however, that such a system would cause poor countries to receive less useful extraterritorial tax information than they currently receive.

<sup>385</sup> In other words, when arrangements involve two parties rather than dozens, it should be easier to correct flaws and to make improvements. Identifying those improvements would also be easier with a deeper pool of examples to use as models.

<sup>386</sup> An important caveat is that such a system would only produce the desired result if, and only if, national governments can be trusted to act in manner that reflects the true interests of their respective populations. With cash as a medium of exchange, a country deciding whether to cooperate in providing information would need to, for example, weigh the value of strict privacy protections against the value of whatever services or benefits the cash payment could allow it to provide. If a government miscalculates its relative values or intentionally undervalues one or the other it might strike a bad bargain from the perspective of national welfare.

<sup>387</sup> See Avi-Yonah, *supra* note 162, at 1575-77 (discussing regressive effect of increasingly taxing labor compared with capital because capital is increasingly mobile).

<sup>388</sup> See *id.*

In theory, an intergovernmental organization could achieve a highly desirable distributional result at both the subnational and international levels. By deciding both what information should be collected and how the economic costs associated with collecting it should be allocated, the organization could ensure that the net benefits of better information sharing are apportioned fairly. Here, the difficulty would be determining what would constitute a fair distribution. Rich and poor countries are likely to disagree on who should finance the operation of the organization.<sup>389</sup> If different countries would benefit disproportionately from access to different sorts of information, choosing which information to target in effect could determine the allocation of benefits. It might be optimistic to think that even an organization like the U.N. has the capacity to strike a balance that each country would perceive to be fair.

A more complete market might succeed in creating distributional balance without the need for the centralized decision-making capacity of an intergovernmental organization. In effect, requiring consumers of extraterritorial tax information to purchase that information would cause them to internalize enforcement costs inherent in their chosen tax regime.<sup>390</sup> If they decide those costs are too high, they would be free to pursue alternative enforcement strategies or to modify their tax systems to reduce the need for extraterritorial tax information. Likewise, sellers would agree to provide extraterritorial tax information only if they find the price offered for that information to be fair. Although a market solution might seem likely to favor the wealthy, when compared with a world in which rich countries compel<sup>391</sup> poor countries to provide them with a significant amount of extraterritorial tax information without paying for it, the distributional consequences of creating a more complete market are relatively appealing.<sup>392</sup>

Either a more complete market or a successful supranational effort would have positive distributional effects within each country, because either would result in greater access to extraterritorial tax information. Conversely, strategies to limit demand would likely have negative distri-

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<sup>389</sup> A rich country might prefer a per-capita funding obligation. A poor country would likely insist on a system based on GDP or some other measure of wealth.

<sup>390</sup> See Ayres & Funk, *supra* note 1, at 83–85 (discussing consequences of failure to internalize costs in the telemarketing context).

<sup>391</sup> That compulsion could be achieved with the threat of sanctions imposed unilaterally or through intergovernmental organizations primarily representing the interests of wealthy countries. See Guttentag & Avi-Yonah, *supra* note 157, at 107 (suggesting possible sanctions against “non-cooperating tax havens”).

<sup>392</sup> See Townsend, *supra* note 369, at 251–58.



butional consequences at the national level. By fostering improved enforcement and a modest amount of base-broadening,<sup>393</sup> better information access could help to ensure that tax systems are as progressive, both nominally and in real terms, as each country desires.

### 3. Privacy

Although it does not get high marks for its welfare or distributional impact, a demand-oriented approach becomes significantly more appealing when privacy interests are granted a privileged status. If we conceive of the protection of taxpayers' "personal data . . . as a fundamental civil liberty interest, essential to individual autonomy, dignity, and freedom in a democratic civil society,"<sup>394</sup> rather than simply a matter of personal preference, it might never be appropriate for a government to exchange or sell that information.<sup>395</sup> From that point of view, limiting information flows would be highly desirable.<sup>396</sup> Nevertheless, impeding data commodification without simultaneously reducing the need for extraterritorial tax information would only worsen the information deficit already hobbling tax authorities' enforcement efforts.

If it were possible to find a perfect balance between protecting information and providing access for tax authorities, an organization like the OECD or U.N. could be ideally positioned to identify it. A policy body able to formulate a distinction between tax-related information that a government never should provide to another and less sensitive information that a government might transfer could pave the way toward alleviating privacy concerns that currently impede the flow of extraterritorial tax information.<sup>397</sup> Alternatively, such an or-

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<sup>393</sup> Lack of access to extraterritorial tax information is only part of what makes it difficult to maintain a broad tax base that includes geographically mobile income such as capital income. Tax rate competition could still inhibit efforts to tax mobile income. See 1998 OECD REPORT, *supra* note 18, at 26.

<sup>394</sup> Pamela Samuelson, *Privacy as Intellectual Property?*, 52 STAN. L. REV. 1125, 1128 (2000).

<sup>395</sup> For some, the mere existence of markets in personal data is objectionable. See, e.g., Jessica Litman, *Information Privacy/Information Property*, 52 STAN. L. REV. 1283, 1301 (2000) ("The market in personal data is the problem. Market solutions [to data privacy failures] based on a property rights model won't cure it; they'll only legitimize it."). Put differently, the question is whether governments should be able to sell personal information, including social security numbers and other personal details, even if private parties are not permitted to do so.

<sup>396</sup> See *id.*

<sup>397</sup> See Blum, *supra* note 25, at 623-33 (discussing privacy concerns particularly relevant to extraterritorial tax information); Zagaris, *supra* note 160, at 379-83 (discussing need for incorporation of taxpayers' rights, including privacy, into international taxation enforcement).

ganization's resources and expertise could allow it to play a key role in devising a more unconventional solution that could simultaneously increase privacy protections and enforcement capacities.<sup>398</sup>

Because attitudes towards privacy, however, like the needs of different tax systems for extraterritorial tax information, vary significantly, it seems unlikely that there is just one answer to the question of how, or indeed whether, to protect taxpayers' privacy.<sup>399</sup> A market that is more flexible than the current one could allow each country to establish its own limits.<sup>400</sup> Conceivably, an exporting country that is unwilling to sell unprocessed, bulk information might be willing to provide information that, although still *ex ante* information, has been filtered to reduce the likelihood that selling the information will harm innocent taxpayers' privacy interests.<sup>401</sup>

Of course, the same flexibility that is the strength of a more complete market could also make it vulnerable to criticism. Complaints that are commonly leveled at markets that stray close to issues of personal autonomy could have considerable force in this context.<sup>402</sup> Poor countries might not be able to afford the same level of privacy protection as wealthier countries.<sup>403</sup> That could create the possibility of relatively rich countries enjoying both adequate extraterritorial tax information and ample privacy protections for its own information while other countries have neither. Although today's incomplete market for extraterritorial

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<sup>398</sup> An example of such a solution might be creating an independent body that would collect tax information from participating countries and act as a clearinghouse or "data aggregator" to identify and highlight potential reporting failures, without providing information with respect to compliant taxpayers to foreign governments.

<sup>399</sup> See Samuelson, *supra* note 394, at 1142 (noting that the concept of information privacy as a civil right is dominant in Europe). In the United States we have become quite comfortable with the idea that information about our income is semipublic. See Blum, *supra* note 25, at 623 (observing that the U.S. tax system is essentially incompatible with information disclosure on solely an investigative basis). Residents of a jurisdiction without an income tax might feel differently and view governmental monitoring of the amount and sources of their income as "snooping." By the same token, U.S. taxpayers might object to having information about their purchases reported to jurisdictions they might have visited that happen to employ a consumption-based tax.

<sup>400</sup> See Samuelson, *supra* note 394, at 1142.

<sup>401</sup> Whether that processed information fetches a higher or lower price would presumably depend on whether the screening method makes the information more or less useful to the recipient.

<sup>402</sup> See Ronald A. Cass, *Coping with Life, Law, and Markets: A Comment on Posner and the Law-and-Economics Debate*, 67 B.U. L. Rev. 73, 75-77 (1987) (listing four categories of objections to applying a market framework in the adoption context).

<sup>403</sup> Cass would consider this a "consequentialist-internal" objection, as it relates to undesirable practical effects on the parties to the "transaction" in question. See *id.* at 75.

tax information raises similar questions,<sup>404</sup> a market in which cash is permitted to change hands in exchange for extraterritorial tax information could put even greater pressure on countries to sacrifice privacy to advance other legitimate government objectives.

### C. *A Better Market*

As the above discussion demonstrates, strong arguments can be made in favor of abandoning the market for extraterritorial tax information entirely and in favor of eliminating the constraints that prevent desirable transactions from taking place. On the one hand, creating a more complete market for tax information, primarily by allowing the use of consideration other than reciprocal extraterritorial tax information, offers the greatest potential benefit in social welfare terms and also seems the most plausible route to satisfying distributional results. On the other hand, the two nonmarket approaches could do the most to protect taxpayers' privacy.

Which approach best suits any given country would depend on its unique needs and circumstances. If the United States, for example, were determined to improve its capacity to acquire extraterritorial tax information, unilaterally moving away from a rigid information exchange approach in favor of a more adaptable market model could help to achieve that goal. Building a broad consensus that such a profound transformation is both warranted and wise would obviously not hurt, but any pair of countries that can be persuaded that such an arrangement would leave each of them better off could enter into an agreement even if no such consensus existed.

One further advantage of a more complete market could be the power it would grant to participating countries to monitor compliance and to punish noncompliance.<sup>405</sup> A carefully crafted agreement between countries would make it relatively easy for each to determine whether a counterparty is adhering to both the letter and the spirit of the bargain.<sup>406</sup> Likewise, by withholding future payments or informa-

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<sup>404</sup> The fundamental premise of the modern information exchange agreement is that a country will consent to provide information in exchange for information that it can use to enforce its tax rules. A poor country could well agree to trade information it would prefer to protect in order to raise tax revenues, effectively selling the information for cash.

<sup>405</sup> See Hathaway, *supra* note 303, at 514.

<sup>406</sup> For example, because the 1939 U.S.-Sweden Treaty clearly specified what was to be provided and when it was required to be provided, it would be much easier to determine whether the United States were fulfilling the information exchange provisions of the 1939 U.S.-Sweden treaty, than the very general requirements of the 2006 model. Compare U.S.-

tion transfers they would be able to unilaterally punish breaches.<sup>407</sup> In effect, such agreements would fill the gap left by the absence of a well-functioning supranational bureaucracy (such as the World Trade Organization). The resulting improvements in both worldwide and national welfare would tend to make any such agreement stable over the long term.<sup>408</sup>

At the same time, the nonmarket approaches could serve as a complement to a more complete market. Even while the strictures of the current barter regime are loosened, individual countries could work to reduce their reliance on extraterritorial tax information while intergovernmental organizations develop standards regarding the types of information that should never be bought and sold. Obviously, the market itself would provide a natural incentive for governments to do the former. The less information a country needs, the less information it must purchase. Banning specific types of transactions or practices would, by contrast, probably require affirmative intervention by an organization like the U.N. or the OECD.<sup>409</sup> That intervention would be most appropriate in situations in which the market (i.e., governments) would be likely to put too low a price on a given type of extraterritorial tax information.<sup>410</sup>

The resulting market would be considerably more flexible than the current one. As in today's barter market, however, not every theoretically possible transaction will be allowed to occur. The difference from the current regime lies in the reason those deals would not be permitted. Now, potential exchanges go unconsummated simply because a reciprocal barter exchange is impossible to arrange.<sup>411</sup> Whether

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Sweden 1939 Treaty, *supra* note 210, art. XVI, with U.S. 2006 Model Convention, *supra* note 16, art. 26.

<sup>407</sup> This would create what Hathaway refers to as transnational legal enforcement, a key element in any successful international cooperative arrangement. See Hathaway, *supra* note 303, at 514. Hathaway concludes that "empirical evidence supports the integrated theory's prediction that where transnational legal enforcement is weak, states will be more likely to commit to and less likely to comply with treaties." *Id.* at 519.

<sup>408</sup> See Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155, 178 (2007) (concluding improvements in worldwide welfare play an important role in maintaining the stability of the international tax regime and in promoting national welfare).

<sup>409</sup> See, e.g., Council of Europe, Convention for the Protection of Individuals with Regard to Automatic Processing of Personal Data (1981), available at <http://conventions.coe.int/Treaty/en/Treaties/Word/108.doc>.

<sup>410</sup> In some cases, any price may be too low. That, of course, is just another way of saying that the sought-after information should never be the subject of a market transaction, even one between governments.

<sup>411</sup> See *supra* notes 318–336 and accompanying text (discussing failures of barter system).

that obstacle prevents countries from entering into productive or problematic relationships is essentially arbitrary. The proposed market, bracketed by limitations designed to provide appropriate privacy protections and other safeguards, would distinguish between productive and problematic transactions on a principled basis.

### CONCLUSION

Markets can be powerful tools, coordinating the demand and supply of all sorts of commodities. In recent years, information has increasingly become just one more good that individuals and businesses find ways to buy and sell. When countries engage in exchanges of bulk taxpayer information, they are participating in just such a market. Unfortunately, those intergovernmental exchanges take place in a barter market that is so incomplete that the resulting exchanges are virtually certain to leave no one satisfied. The current framework rests on a requirement that governments may only acquire tax information with identical tax information. In doing so, it fails to accommodate the many differences among countries and their tax systems that produce a range of both needs for and abilities to produce tax information. The result has been a market in which only the most basic extraterritorial tax information demands—those that are most likely to be common among all countries—are likely to be met.

The United States, for example, has found itself facing a growing disparity between the information it collects domestically and the information it is able to acquire from abroad. At the same time, globalization and technological change have made the ability to acquire useful extraterritorial tax information more important than ever. To acquire the information it needs for the income tax to function effectively in today's borderless economy, the United States must abandon the antiquated notion of information exchange. Working to create a more complete market, one more likely to facilitate efficient transactions than today's barter market, is one possible remedy. The United States could also choose to (1) promote a supranational effort like the European Union Savings Directive to facilitate cross-border flows of tax information, (2) unilaterally reduce its dependence on extraterritorial tax information, or (3) to pursue all of these possibilities simultaneously. Any of those strategies would be more likely than the current eighty-year-old barter method to ensure that the United States receives the extraterritorial tax information it needs.